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# *The* JOURNAL of ACCOUNTANCY

VOLUME LI

MARCH, 1931

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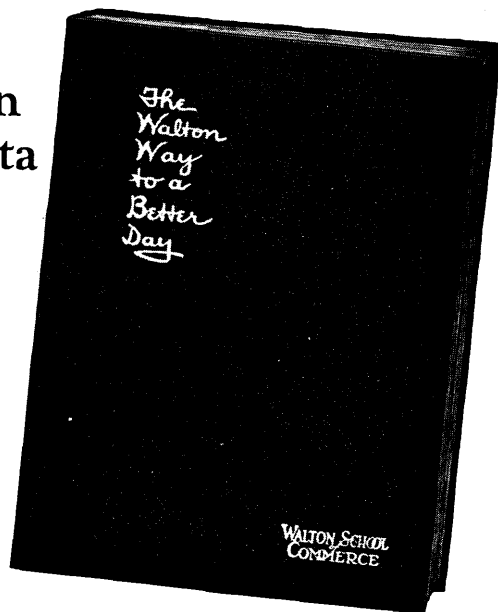
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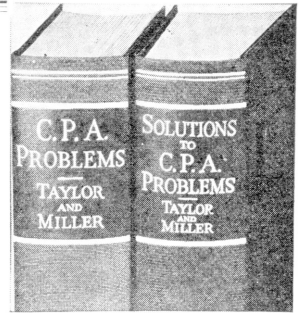
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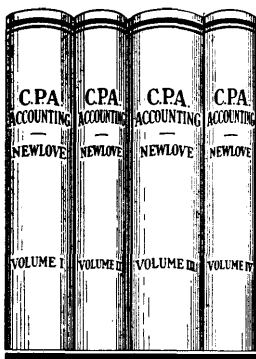
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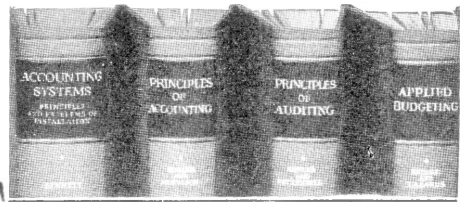
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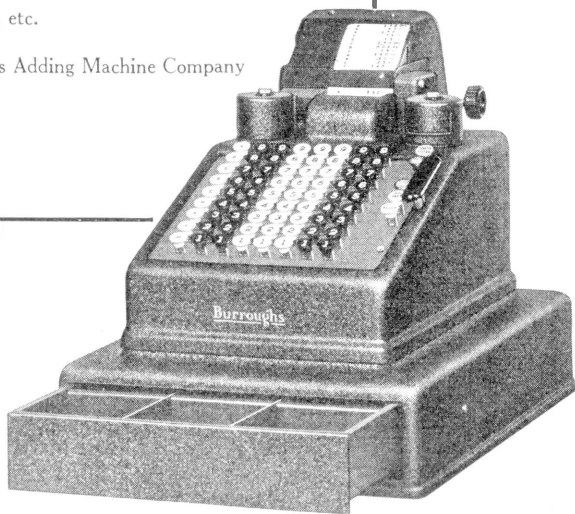
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VOL. 51

MARCH, 1931

No. 3

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## EDITORIAL

### **The Suicidal Practice of Bidding**

An eminent authority writing on the subject of price cutting among public accountants gives some extraordinary details. He says that an engagement performed by his firm last year at an actual cost of \$8,000 was undertaken this year by a firm which bid for the work at a price of \$4,000 "flat." In another case an engagement for which the firm rendered a bill of \$17,500, was done by another firm, also after bidding, for a flat fee of \$7,500. This is a most striking illustration of the fallacy of bidding flat fees. Unfortunately there is nothing in the rules of conduct prescribed by the Institute which forbids the quotation of flat fees and it would be difficult to devise a rule which would fit the case. There are many instances in which an accountant may accept engagement on what is practically a retainer agreed in advance. Technically that might be described as a flat fee, but there is nothing at all in the highest standards of professional ethics to prevent the acceptance of a fixed retainer. Consequently to prohibit all flat fees would be absurd and probably fatuous. On the other hand it would be perfectly possible to enact a rule prohibiting competitive bidding, and that, we believe, will be one of the next rules adopted by the council of the American Institute of Accountants.

### **The Danger Will Be Seen**

It has been repeatedly said that the way in which to bring about abolition of bidding is to refrain from bidding. If all accountants will refuse to enter this form of competition, those who call for bids will be compelled to adopt some other method of obtaining the professional services which they require. The



chairman of the committee on professional ethics of the Institute recently said, "Quoting flat fees blindly is an evil that unfortunately is not covered by the rules of conduct. However, it violates the unwritten rule that accountants should maintain the dignity of the profession. Some day accountants will realize the harm that results." This is good doctrine. The accountant who bids places himself inevitably on a level with business and the public will no longer regard him as a professional man—that is to say the portion of the public possessed of discernment will not. Competitive bidding on the part of business men is eminently proper in the present state of commercial and industrial development. Sometime there may come a day when competition will be unnecessary, but none of us now living will witness it. Professional life may be no whit better than commercial life, and sometimes it is certainly far inferior, but the two things are never the same and it is idle to attempt to judge one class by the tenets of the other.

**The Immediate Effects of Bidding**

Now, take the case mentioned above, in which an engagement amounting in one year to \$17,500, was undertaken by another firm for \$7,500. Even if, for the sake of argument, it be admitted that perhaps the fee of the first firm was high, no one could possibly believe that it was \$10,000 too high. The work in the second year was to be practically the same and yet another firm professed a readiness to undertake it for \$10,000 less than the fee of the preceding year. There is only one answer and that is that the second firm in its eagerness to find occupation knowingly or ignorantly undertook a task which was certain to lead to a loss or to a failure to perform the full service required. There is no other way out a difficulty of that sort. Either the client loses if the accountant be dishonest or the accountant loses if he be honest. Both results are bad and both are the outcome of the reprehensible practice of bidding flat fees. Naturally a client may wish to know approximately what will be the expense involved in the employment of accountants and it is probably permissible for the accountant to estimate roughly what his fee will be. He may even go so far as to say that the fee will not exceed a certain amount, provided that that amount is sufficiently large to meet any combination of circumstances apt to arise. But it were infinitely better to avoid all fixity of fees and to have that relationship between client and accountant which exists in most

cases between client and lawyer. The man who has confidence in his lawyer or accountant should not find it necessary to enter into a hard and fast agreement on the question of prices. His confidence should run to the extent of confidence in the reasonableness of the professional man's fees. If it is needful to inquire exactly how much professional services will cost there must be a lack of that pure confidence which is always to be desired. More and more accountants are seeking to get away from the old rule that the per-diem rate should always prevail. Obviously, in the case of routine audit the per-diem rate is the best index of amount, but in all work requiring peculiar knowledge and exceptional judgment it is unfair to expect the accountant to charge a fee based solely upon the number of days devoted to the work. The whole question of accountants' fees is in an unsettled condition. Some firms have reached a point where they are not greatly disturbed by controversies over fees, but most accountants know to their sorrow that there are clients whose unchanging conviction it seems to be that the accountant's fee should always be disputed. Those who favor the flat-fee basis point to such clients and say, "Here is our reason for favoring the flat fee. It is not subject to dispute." And it must be confessed that there is a great deal of apparent logic in their contention. But, to go deeper, one finds that the fault lies in the mistaken theory of the client and of some accountants that the charge will be based upon whatever the traffic will bear rather than upon a "sweet reasonableness." As we have said, the way to bring an end to these undesirable conditions is by a universal refusal to have anything to do with competitive bidding.

**Depreciation and  
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In a statement recently issued by a prominent realty company, the following paragraph appears:

**"DEPRECIATION**

"A charge is set aside annually for depreciation on the companies' buildings figured on a sinking fund basis at the rate of six per cent. per annum that a thoroughly modern fire-proof building kept in repair will last for seventy-five years. The companies' buildings and their equipment have been kept in thorough up-to-date repair and the increase in their reproductive cost would largely be in excess of any depreciation since their erection." This is a most interesting illustration of the extremes to which

those who favor the sinking-fund provision for depreciation may be led. Let us analyze the quoted statement. In the first place there will be a wide difference of opinion as to the justification for an expectation of seventy-five years' life. The great changes which are taking place in architecture and the use of buildings is such that he is indeed a brave man who would predict beyond a score of years. Even assuming, however, that a building may in the most favorable circumstances continue its useful life for seventy-five years it would be unwise to count upon any such length of life. Looking over the buildings of New York, or any other great American city, it would be difficult to find any building used for commercial purposes which has had a life of even half of seventy-five years. Of course we are not speaking now of the old houses which have been converted to commercial uses from an earlier purpose. The subject is now the large commercial venture.

#### **The Sinking-Fund Theory**

Passing that point for a moment, however, it is interesting to consider the statement that the depreciation is computed on a sinking-fund basis at the rate of six per cent. per annum. Presumably this involves compounding the interest annually. Now, in order to create a sinking fund on such a basis over a life of seventy-five years it would be necessary to set aside merely one thirteenth of one per cent. annually. Such is the force of interest compounded that one thirteenth of one per cent. annually in seventy-five years would amount to one hundred per cent. But this involves the ability to reinvest immediately at all times on a productive basis of six per cent. net. Not only that, but taking corporation income tax at the present rates, in order to produce six per cent. net the interest earnings must be increased by .82 per cent., and this of course increases the requirement to an ability to reinvest at 6.82 per cent. per annum. The company which can do this is highly favored by heaven.

#### **The Force of Com- pound Interest**

Another illustration of the force of interest and what we believe to be the fallacy of the so-called sinking-fund basis for depreciation is that if the expected life of a building were reduced from seventy-five to fifty years, it would be necessary to increase the rate of depreciation allowance four times in order to attain amortization of the principal; and if we bring the expected life down to a reasonable duration of, say, thirty years,

the rate must be increased more than three times again, so that by reducing extravagant expectation of life to something within the bounds of probability the rate of allowance for depreciation must be increased approximately fourteen times. There is no particular objection to the statement made by the company that depreciation is charged as it is charged, but it would be infinitely better, it seems to us, that there should be an adequate allowance and that even the casual reader might be put on notice. In the auditors' report the following reference to the matter occurs:

" . . . . . With respect to depreciation the accompanying consolidated balance-sheet and income account reflect only the provision therefor established by the companies. In the case of office and hotel buildings, depreciation has been computed on a 75 year 6% sinking-fund basis.

"Subject to the comments in the preceding paragraph, we certify that, in our opinion, the accompanying consolidated balance-sheet and condensed income account fairly present the financial position of the companies at December 31, 1930, and the results of their operations for the year ended that date."

This note of warning will be sufficient for the admonition of persons experienced in financial mathematics.

**Depreciation  
*ab initio***

It has been suggested by an accountant, who delights in computations, that the whole question of allowance for depreciation might be answered at the time of the foundation of the company by setting aside one dollar and a quarter out of every hundred dollars and placing that sum at compound interest with the assistance of the peculiar financial ability to invest and reinvest at 6.82 per cent. per annum and thereafter make no further provision for depreciation at all, allowing the original allotment of one dollar and a quarter to work out the salvation of the whole company. Interest is an extraordinary thing and there may be a great deal of merit in the suggestion to which we have referred. All that is necessary to bring about complete success for the proposal is a life beyond the normal span of man or building and the continuance of an extraordinarily high rate of interest over that long life. If these can be assured the rest is easy.

**Scottish Accountants  
Honored**

A recent issue of *The Weekly Scotsman*, the paper which most Scotsmen would probably describe as the leader in its field, contained a brief report of a dinner given at the North



British station hotel, Edinburgh, when Lord Provost Thomas B. Whitson of Edinburgh and Lord Provost Thomas Kelly of Glasgow were the guests of honor. The occasion was noteworthy because it was the first time when both lord provostships had been held by chartered accountants. The office of lord provost in Scotland is equivalent to that of lord mayor or chief magistrate in England, and here we find the capital and intellectual center of Scotland and the great commercial center electing to the office of lord provost members of the profession of accountancy. It is customary for anyone filling the position of lord provost to receive from the king a baronetcy, or at least a knighthood, upon retirement from office. Elevation of two chartered accountants to occupy these high positions is a striking honor to the profession in the country where accountancy was first recognized as a profession. We extend cordial congratulations to Lord Provost Whitson and Lord Provost Kelly and to the profession in their great country.

**Accountants in International Affairs**

The settlement of the Mexican debt question, announced recently in the daily papers, is an excellent illustration of the place which accountancy may occupy in international affairs. The complexity of the Mexican debt, affected by the changing political conditions and the grave decline in the value of silver, called for expert opinion and it is gratifying to know that in this vitally important question the two countries most concerned, namely, Mexico and the United States of America, were represented by professional accountants. To their competent analysis of the various factors involved is almost wholly due the success which attended the negotiations. The accountancy profession is to be congratulated upon having rendered this important service to the fair settlement of a matter of vital interest to the two countries.

**Accommodations for the Audit Department**

A correspondent who evidently knows whereof he speaks sends us the following directions for companies employing accountants. The question of finding accommodations for the audit department is the text upon which the argument is based.

Then follow these twelve excellent rules:

1. Choose as noisy an office as possible, preferably near a street-car intersection or corner with automatic traffic signals.

2. Exclude daylight with partitions and window shades. Arrange artificial light so that workers at desks will always be in their own shadow.

3. If a factory, place the accounting department immediately over a boiler shop, near plant whistle signal, riveting machines and trip-hammers.

4. Fix office telephones close to auditors' desks so that people using them can shout down the accountants when calling over postings, etc.

5. Have a few typewriters, billing machines and addressographs hammering incessantly within hearing of auditors.

6. Arrange broken swivel or tip-up chairs for accountants, either too high or too low for the desks. Chair legs, of unequal lengths, should emit squeaks when the occupant moves, breathes, speaks or clears throat.

7. Modulate ventilation and heating so that auditors are always either roasted or frozen, according to the season.

8. See that the required books and records are put away in vaults, cellars or cupboards, preferably in newspaper parcels with no exterior indication of the contents, and with the keys mislaid.

9. Arrange for inadequate safe accommodation for the books in use, so that half an hour or more must be wasted every evening in putting them away.

10. Have all adding machine tapes within a few inches of exhaustion, and no more in stock. A delay of a day or two should occur in replacing these.

11. Typists assigned to assist auditors should be blissfully ignorant of figures and have had no experience with tabular work.

12. Complain violently at the unreasonable length of time consumed on the work and at the exorbitant amount of the bill.

This admonition to companies is somewhat similar to the rules laid down by a conductor of the orchestra at the Metropolitan opera house in New York urging all patrons to arrive late, to rustle newspapers and programmes, to push past other patrons, to talk, to cough and to do a hundred other things which are encouraging to the artists on the stage.

#### **Inventory Valuation Again Arises**

A correspondent in Utah commenting upon editorial notes which appeared in the December issue of *THE JOURNAL OF ACCOUNTANCY*, says that he believes from the general trend of comments that this magazine is not in favor of the theory that the accountant should certify the physical count and quality of inventory. He continues: "It happens that I was invited to give a lecture before a body of bankers on the topic 'The analysis of the financial statement.' The value to the banker of an audit of

the accounts of a customer by a certified public accountant was touched upon. During the discussion one member, who had been the bookkeeper for a rather large mercantile institution, and had later taken up the occupation of banking, raised a question concerning the verification of inventory. He said that he had seen several audits, both by local firms and also by firms of nationwide activities, and that he had never yet seen any serious effort to verify the inventory. About all that any of the auditors did was to check a few extensions, ask a few questions, perhaps look at a few invoices, get a certificate from the manager or some other officer of the company, and pass the problem without any physical count or check. 'Now,' said this banker 'the inventory is the most flexible item on the balance-sheet. Here, if anywhere, there is a chance for padding. Of what value to the banker is an audit which passes up such a problem without any serious effort at checking it?' And now, Mr. Editor, let me pass the question up to you. Of what value to the banker is a certified statement when the inventory has not been checked?"

**Reaching Out for  
the Moon**

This is an old question but one that seems to be of perennial interest. We may admit at once that if it were possible for the accountant to certify that the statement of inventory was correct in every way it would be a most happy consummation. It would also be delightful if the accountant could certify to the health of all the employees of a corporation or could guarantee the success of every commercial venture. But the truth of the matter is that he could do none of these things because he has not, and except in rare instances can not have, the requisite knowledge. It would be almost as easy to give a certificate of health of personnel as of accuracy of inventory. It is all fine enough for the banker to say that he wants this or wants that. We all do. Everybody wants everything he wants, but that does not bring the unattainable to hand. As has been said repeatedly, there are a few small businesses or businesses having a very much restricted variety of output, in which an accountant familiar with them can certify as to correctness of inventory. But they are so few that they do not affect the general principle. The trite examples of a jeweler's shop, a department store, a steel mill and others might be cited again to demonstrate how impossible it is for an accountant to know enough of measurements and qualities to express an

opinion of any significance. This has all been said many times, but it might be said further that the banker who expects an accountant to be an appraisal company and an insurer has lost sight of the function of an accountant, and the accountant who, except in the rare instances mentioned, assumes liability for the accuracy of inventory count and value is courting disaster. Furthermore, the question of the banker, as to what value there could be in an accountant's certificate which did not cover inventories in detail, must have been asked by a banker unacquainted with the true nature of accountancy. It may be flattering to the accountant to tell him that he is to know all things, but if the accountant is not a fool he will admit that there are some things which he can not know. Of course this does not mean that the accountant should not exercise every precaution available to him to see that the inventories are correctly stated. It does mean that the accountant can not guarantee the accuracy of the ordinary inventory of merchandise in either quantity or quality.

**The Other Side of  
Restrictive Laws**

The attention of readers is directed to a letter from Arthur Berridge, a member of the American Institute of Accountants and a member of the American Bar Association, appearing elsewhere in this issue of *THE JOURNAL OF ACCOUNTANCY*. This letter discusses the validity of restrictive legislation affecting the profession of accountancy. It is an able exposition of the side of the question opposed to that adopted by this magazine. We are glad indeed to have an opportunity to publish so calm and well reasoned an expression of the opposition's view. We may disagree with the theory that restrictive legislation will be held constitutional in most of the states, but it is certain that the question must be brought to adjudication, and if every one will approach the matter in the same fair and friendly manner as that displayed by Mr. Berridge we shall go far toward an amicable solution of a much vexed problem. The trouble with most of us is that when we take sides we forget that they are sides and not the whole question. It is easy to be intolerant—terribly difficult to be tolerant. In a question like that of restrictive legislation there is so much personal feeling that calmness is rarely attained, and we therefore commend Mr. Berridge's letter to the careful consideration of those who agree and those who disagree with him. He appears to us to have taken the wrong side but he has taken it so pleasantly



that he seems to be one of those who "do as adversaries do in law—strive mightily, but eat and drink as friends."

**"The Customer Is  
Always Right"**

It is the custom among many enlightened business concerns to adopt the policy that the customer is always right and upon this fundamental theory some of the greatest business fortunes of the country have been built. The thesis is, of course, that the amount of loss involved in unjust claims by customers will be more than compensated by the increased prestige and advertisement created by the reputation for making good. Here again, however, the essential differences between the principles of business and profession are clearly manifest. Whereas the business man may say that the customer is always right, the professional man may be almost justified in saying that the client is always wrong. A correspondent says "there may be some excuse for the adoption by a merchant of such a slogan and the practice which its adoption implies, possibly on the grounds that the usual matter complained of by the customer is trivial and time and money are saved by unquestioned acquiescence with his views. Even where the matter is not trivial, a reputation for service and amiability may create a goodwill offsetting the cost of the adjustment. Viewing it from an ethical basis, is it not a servile bending of the knee to the almighty dollar carried by the so-much-to-be-desired customer? We are now in the midst of a period of window dressing, when not only the shop windows are dressed, but the same treatment is being applied in some instances to the accounts of a bad business year and the annual reports to stockholders. This is a good time to show whether the public accountant is a shop-keeper or a professional man; whether he bends the servile knee and adopts the slogan 'The customer is always right' or whether he has the professional training and instincts to resist attempts at chicanery, even at the cost of losing the 'customer'."

**Slogans Not for  
Professions**

It will be remarked that the correspondent quotes the word "customer" when speaking of some practices, and we think it might be safe to infer that the accountant who would be guilty of an undue recognition of a client's claim that this or that was so without verification could be regarded as engaged in business and therefore his clients would be customers. Slogans

are frequently silly and often dangerous. The catch word "the customer is always right" is supposed to be the antithesis of the older expression, written in doubtful Latin, "caveat emptor" and it is said to mark the transition from old custom to new. In the case of professions the adoption of slogans may be even more dangerous than it is in business, but if slogan there is to be, for any profession, it should be "the client is not right unless he is found to be." The correspondent who sends these opinions is moved by the contemplation of a real weakness of all the professions. It is particularly evident in a time when business depression leads to inactivity of professional offices. The professional man like every other man wants to make a decent living and sometimes he may be tempted to obliterate the word "decent" by too much willingness to kowtow to the demands of clients. It is not true, however, that the number of subservient professional men constitutes an appreciable percentage of the total. We believe that most professional men are ready enough to consign the unreasonable or crooked client to the depths, even at the cost of a fee.

## Application of Payments

BY L. L. BRIGGS

If a debtor, who owes several separate amounts to one creditor, makes a payment which is less than the total debt or less than any one of its constituent parts, the problem of applying the payment arises. Since the accountant may have the duty of solving this problem, a general knowledge of the legal principles governing such applications should prove helpful to him. Some of the more important legal aspects of payment applications are considered in this article.

The debtor has the right to indicate his wishes in respect to the application of a voluntary payment. According to Chief Justice Marshall in the leading case of *Taylor v. Sandiford* (1822) 7 Wheat. (U. S.) 13:

“A person owing money under distinct contracts has undoubtedly a right to apply his payments to whatever debt he may choose; . . .”

In *Monidah Trust Company v. Hruze* (1921) 62 Mont. 444, the court said:

“The reason for the rule which confers upon the debtor the right primarily to direct the application of a payments voluntarily made by him is apparent. Until the money it actually paid over, it belongs to him, and he may do with it as he sees fit.”

If the creditor accepts the payment, he is bound by this action to obey the directions of the debtor, even though at the time he refused to admit them (*In re Interborough Construction Corporation* (1923) 288 Fed. 334). The court, in *Monidah Trust Company v. Hruze*, expressed the principle in these words:

“If he (the debtor) makes a specific direction, the creditor must observe it or refuse to accept the payment. If he (the creditor) accepts and retains the money, the law will treat the payment as having been applied as directed.”

In *Reed v. Boardman* (1838) 20 Pick. (Mass.) 441, the debtor sent the creditor a sum of money with notice as to which account it was to pay. The creditor refused to accept the payment on those terms and refused to admit the payment on that account

but did receive and retain the money. The court held that the retention of the payment bound him to make the application specified by the debtor.

The direction of the debtor is usually in the form of an express declaration, although it may be a written or an oral agreement between the debtor and the creditor (*Hansen v. Rounsavell* (1874) 74 Ill. 238). If the application is in words, these words must reach the creditor in order to bind him (*Pearce v. Walker* (1875) 103 Ala. 250). However, the debtor is under no obligation to make a definite statement in regard to the appropriation, since his intent, if this is made known, is sufficient. Chief Justice Marshall, in *Tayloe v. Sandiford*, cited above, said in regard to this point:

“ . . . although prudence might suggest an express direction of the application of his (the debtor's) payments at the time of their being made; yet there may be cases in which this power would be completely exercised without any express direction given at the time.”

If no precise designation has been made, it may, of course, be necessary for the debtor to prove facts that will lead a jury to infer that he actually intended the specific application which he claims (*Hall v. Marston* (1822) 17 Mass. 575).

Circumstances may reveal the debtor's intent as to payment applications as well as words could indicate. For example, the denial of one debt and the acknowledgment of another with delivery of the sum due upon it would be conclusive evidence of the payer's intention (*Marryatts v. White* (1817) 171 reprint 586). If there are two debts, of one of which the debtor is aware, of the other of which he is ignorant, an intention to pay the known debt is presumed (*Burchard v. Western Commercial Travelers' Association*, 139 Mo. A. 606). Should the creditor demand payment of one of two or more debts and the debtor pay, the law considers the payment to be on the demanded debt (*Smith v. Mould* (1914) 149 N. Y. S. 552). Where the debtor inquires as to the amount of a particular debt and then pays that amount, the intention to pay the debt about which he inquired may be reasonably inferred (*New York v. Angelo* (1911) 129 N. Y. S. 713). However, if circumstances are depended upon to indicate the application, it is essential that knowledge of them reach the creditor, because the mere intention on the part of the debtor to appropriate, of which the creditor is unaware, will not bind the



latter (*Delaware Dredging Company v. Tucker Stevedoring Company* (1928) 25 Fed. (2d) 44).

Should the debtor pay with one intent and the creditor receive with another, the intent of the former will govern.

After the debtor has made the application, the creditor has no right to divert the money without the consent of the payer (*Treadwell v. Moore* (1852) 34 Me. 112). Should the creditor apply the money upon a debt, other than the designated obligation, and the debtor fail to object, such failure to act is not necessarily an acquiescence to the appropriation made by the creditor (*Ballantine v. Fenn* (1914) 88 Vt. 166) because the debtor may be ignorant of the diversion (*Fargo First National Bank v. Roberts* (1891) 2 N. D. 195).

An entry made by the debtor on his records when the payment is made is an appropriation if this fact is communicated in some way to the creditor (*Stone v. Rich* (1912) 160 N. C. 161). If the creditor receives a payment and credits a particular item in the debtor's account and then notifies the payer of that entry, and he makes no objection, such action is considered a consent to the application by the creditor (*Seymour v. Marvin* (1851) 11 Barb. (N. Y.) 80). If the creditor fails to notify the debtor of the entry, the creditor's action is taken as evidence of an application by some of our courts (See 3 Williston, *Contracts* (1920), Section 1799). However, the English view, that such entries have no effect, seems more reasonable (*Simson v. Ingham* (1823) 2 B. & C. 65).

The law sets a time for application of the debtor by stating that he must make it at or before the time the creditor receives the money (*California Bank v. Webb* (1884) 94 N. Y. 467). One court (*Petty v. Dill* (1875) 53 Ala. 641) maintained that the debtor must act, at least, before the creditor has applied; but, even where the creditor has not applied, the debtor is not permitted to direct application long after the payment has been made (*Dean v. Womack*, 2 Tenn. Ch. A. 72) without the consent of the creditor (*Royal Colliery v. Alwart* (1916) 276 Ill. 193). The court, in *In re American Paper Company* (1919) 255 Fed. 121, held that the debtor may not apply a payment after litigation in regard to it has been instituted.

The debtor may, at the time of payment, change a direction previously given (*Ray v. Borgfeldt* (1915) 169 Cal. 253) but after payment has been made he has no right to change the appropria-

tion without the creditor's consent (*Hodge v. Hoppock* (1878) 75 N. Y. 491). But should the creditor consent to change of application after payment he will be bound by such agreement (*Thompson v. Reeves* (1926) 170 Ark. 409).

Where the debtor makes a voluntary payment and fails to make a definite designation and gives no indication of his intention as to the application of the payment, the creditor, with certain restrictions which will be taken up later, is given the right to apply the payment to any one of the several debts that he sees fit (*United States v. Kirkpatrick* (1824) 9 Wheat. (U. S.) 720; *Jones v. United States* (1849) 7 How. (U. S.) 681; *In re Lindau* (1910) 183 Fed. 608). Chief Justice Marshall, in *Field v. Holland* (1810) 6 Cranch. (U. S.) 28, said:

“ . . . When a debtor fails to avail himself of the power which he possesses, in consequence of which that power devolves on the creditor, it does not appear unreasonable to suppose that he is content with the manner in which the creditor will exercise it.”

The performance of some act which shows the intention specifically to apply the payment to a particular debt constitutes appropriation on the part of the creditor (*Reynolds v. Patten* (1894) 30 N. Y. S. 1050). Circumstances as well as express declarations may indicate the creditor's intent (*Felin v. First Mortgage Guarantee* (1915) 248 Pa. 195). However, the mere intent to apply is not sufficient, according to the court in *Schoonover v. Osborne* (1902) 117 Iowa 427).

These are some of the acts which are evidence of application on the part of the creditor: entry of credit on a particular account (*Jones v. United States* (1849) 7 How. (U. S.) 681); indorsement of payment on a note (*Sanborn v. Cole* (1891) 63 Vt. 590) if notice be given the debtor; institution of a suit by the creditor, in the jurisdictions where the creditor may apply at any time prior to judgment or verdict (*State v. Blakemore* (1918) 275 Mo. 695).

Naturally, the creditor will wish to apply the payment to the item or items which he thinks are least likely to be paid, and, with certain restrictions, the law will support him if he makes such an appropriation (*Hildreth v. Davis*, 6 Kulp (Pa.) 336). If other rules do not prohibit, he is given the right to apply the payment to debts not secured (*Turner v. Woodard* (1919) 259 Fed. 737) or he may select the most precarious of the secured claims. (*In*

re *Lysaght* (1903) 1 Ir. 235). If one of the debts is the sole obligation of the debtor, and the others are with surety, guarantor or joint debtor, the creditor may apply a general payment by the debtor from his own funds to the debt which is not protected and continue to hold the surety or others bound. If one debt is a bond, or covenant under seal, and the other is by a simple contract or open account, the creditor may appropriate a payment to the latter (*Mayor v. Patten* (1808) 8 Cranch (U. S.) 317). Should one debt be by judgment and the other by simple contract, the creditor has the privilege of application to the latter (*Richardson v. Washington Bank* (1842) 3 Metc. (Mass.) 536). In case of two different accounts, one of which is later than the other, the creditor, if he so desires, may apply the payment to the later account (*Henry Bill Publishing Company v. Uiley* (1892) 155 Mass. 366) or he may apply half of the payment to each of the accounts if neither is barred by the statute of limitations (*Beck v. Haas* (1892) 111 Mo. 264).

Although there are some contrary decisions, the general rule, in respect to running accounts, is that the creditor may apply the payment as he chooses (*Sheppard v. Steele* (1870) 43 N. Y. 52). Consequently, he may apply to the oldest items (*Jones v. United States* (1849) 7 How. (U. S.) 681) even though these items are barred by the statute of limitations (*Brown v. Osborne* (1910) 136 Ky. 456). However, if he applies without making known his intention to apply to a specific item, the presumption is that he applies to the oldest (*American Woolen Company v. Maaget* (1912) 86 Conn. 234).

There are some restrictions upon the rights of the creditor to apply when the debtor fails to exercise his privilege of appropriation. The courts insist that the debtor must have known and have voluntarily given up his right to direct the application of the payment which he has made before the creditor may apply. In *Bancroft v. Dumas* (1849) 21 Vt. 456, the court went so far as to hold that the creditor must make the application in such a way that the debtor could have no reasonable objection. In some circumstances, on account of the relation in which he stands to third persons, or from agreement with them, expressed or implied, he may be obliged to make a particular appropriation. For example, if the debtor who owes the creditor also owes a party for whom the creditor is trustee, a general payment by the debtor must be applied pro rata between the creditor's debt and

that of the party for whom he is trustee, since a trustee is bound to take the same care of his cestui que trust's interests that he does of his own (*Scott v. Ray* (1836) 18 Pickering (Mass.) 361). A prior legal debt must be given preference over a later debt in equity. If there are several debts, and only one of these is valid, the creditor must apply the payment to this debt, without any consideration whatever of the order in point of time in which this item appears on the records (*Backman v. Wright* (1855) 27 Vt. 187).

If a debt is due at the time an unappropriated payment is made, the courts assume that the creditor will apply the payment to such debt, in preference to those which are not due at that time (*Baker v. Stackpoole*, 9 Cow. (N. Y.) 420). The creditor may apply the payment to debts which are not due, if he has an express agreement with the debtor to that effect (*Shaw v. Pratt* (1839) 22 Pick. (Mass.) 305) but he is under no obligation to receive payment of such a debt and if he accepts the money he must apply it as the payer orders (*Levystein v. Whitman* (1877) 59 Ala. 345).

The creditor has no right to apply unappropriated funds to claims that are illegal and consequently are not recoverable at law (*Caldwell v. Wentworth* (1843) 14 N. H. 431). In *Richardson v. Woodbury* (1853) 12 Cush. 279, it was held that if payments made on account by a debtor be applied by the creditors, under a previous agreement, to certain items of the account which are illegal, such payments are valid, and can not afterwards be revoked by the debtor. This seems to be a recognition of the principle that a debtor may elect to have his payment applied to an illegal debt. In an early Maine case, *Treadwell v. Moore* (1852) 34 Me. 112, the court decided that debts resulting from the sale of liquor, which was illegal in Maine by statute, might be legally credited if the payment was applied by the debtor.

The courts have refused to allow a creditor to apply an unappropriated payment to debts barred by the statute of limitations with the object of reviving them (*Pond v. Williams* (1854) 1 Gray (Mass.) 630). However, the debtor has the right of waiving the bar of the statute and may permit such an application as will renew the former obligations. If he remains silent after learning that the creditor has applied the payment so as to revive the outlawed debt, he will be estopped from denying that the money was paid on such debt (*Watt v. Hoch* (1855) 25 Pa. 411). Usually, the creditor has the burden of proving the intent of the

debtor to renew the outlawed obligation. This intent may be inferred from accounting entries which were made before the payment or from the fact that the debtor has paid interest on the renewed debt. The payment, if part, will generally be applied toward the barred debt if such is the desire of the debtor, but the balance of the debt is not revived (*Pond v. Williams* (1854) 1 Gray (Mass.) 630). In *Ayer v. Hawkins* (1846) 19 Vt. 26, the court decided that a creditor may apply a general payment to any one of several barred accounts, and this payment will revive the balance of that particular account, but he will not be permitted to distribute the credit among the several accounts, so as to revive them all.

The civil law requires that the creditor make the application of a general payment very soon after receiving the money from the debtor; but the common law is more liberal. There is considerable conflict among the decisions as to how long the right exists for the creditor. A few dicta indicate the necessity of applying within a reasonable time. Between debtor and creditor, the weight of authority is that an application by the latter at any time before a controversy arises or a suit is brought will be good (*Bacon v. Dollar Steamship Lines* (1923) 290 Fed. 964; *Pierce v. Knight* (1859) 31 Vt. 701). If third parties are involved, the creditor must act within a reasonable time (*Robinson v. Doolittle* (1840) 12 Vt. 249). When the time arrives for the creditor to declare his election, he may not refuse to do so, and he will not be permitted, to the inconvenience and injury of others, to hold the application in reserve to await the turn of future events. The rule is different in England, for in that country a creditor has been allowed to apply in the witness box (*Seymour v. Pickett* (1905) 1 K. B. 715).

Application by the creditor may become fixed by oral declaration; by the terms of the receipt rendered; by rendering an account; by bringing a suit based upon a specific appropriation; or by any other act showing an intent or inducing a belief that a particular application has been made (*Allen v. Kimball* (1839) 23 Pickering (Mass.) 473).

After the appropriation has been made by the creditor, he can not change it without the consent of the debtor (*The Sophia Johnson* (1916) 237 Fed. 406). If the debtor consents, any change agreeable to both parties is generally permissible (*Thompson v. Reeves* (1926) 170 Ark. 409).



The creditor has no option with regard to application if the payment is involuntary on the part of the debtor (*Blackstone Bank v. Hill* (1830) 10 Pickering (Mass.) 129). He is under obligation to apply the payment pro rata to all the unpaid accounts. This rule is followed where the creditor obtains the money through judicial proceedings. The share received by a creditor from an insolvent debtor through an assignment must be applied pro rata to all the claims against the debtor and not only to such debts as are otherwise unsecured (*Bank of Portland v. Brown* (1843) 22 Maine 295).

If no application has been made or indicated by either the debtor or the creditor, the duty of appropriation falls upon the court which will usually apply the payment as it sees fit with due consideration to the interests of both parties (*Harker v. Conrad* (1825) 12 Serg. & R. (Pa.) 301; *Pope v. Transparent Ice Company* (1895) 91 Va. 79). According to Justice Story, in *United States v. Kirkpatrick* (1824) 9 Wheat. (U. S.) 720:

“The general doctrine is that the debtor has a right, if he pleases, to make the appropriation of payments; if he omits it, the creditor may make it; if both omit it, the law will apply the payments, according to its own notions of justice.”

In some circumstances, the jury, acting on the evidence and under instructions of the court, will apply (*Oliver v. Phelps* (1843) 20 N. J. L. 180).

The court will attempt to follow the intention or understanding of the parties, before or at the time of payment, if this can be inferred or implied from the circumstances (*Emery v. Tichout* (1841) 13 Vt. 15; *Gillett v. Depuy* (1900) 63 N. Y. S. 49) but if this is impossible, it will be guided by a general presumption of intention founded on reason, probability and justice. In *The Martha* (1887) 29 Fed. 708, it was held that that application is presumed to have been agreed upon to which it is most probable that the parties would have assented.

The law will usually apply a general payment to a debt which is due, in preference to one that is not due, since the presumption is that the debtor intends a payment, not a deposit (*Upham v. Lefavour* (1846) 11 Metc. (Mass.) 174). A certain debt is preferred to one which depends upon the happenings of some contingency (*Snyder v. Robinson* (1871) 35 Ind. 311; *President v. Brown* (1843) 22 Maine 295). The application will generally be made to the oldest of several debts (*Kloepfer v. Maker* (1903)

84 N. Y. S. 138). If priority is not involved, that debt which is unsecured or is least secured will receive the credit in the states following the common-law rule (*Barbee v. Morris* (1906) 221 Ill. 382). In case the debt which is least secured is not prior to the others, there are several decisions to the effect that the time element should be ignored and the application made to the least secured obligation (*Schuelenberg v. Martin* (1880) 2 Fed. 747; *Smith v. Lewiston Steam Mill* (1891) 66 N. H. 613). However, the weight of authority favors application to the earliest debt (*Moses v. Noble* (1888) 86 Ala. 407; *Wortheley v. Emerson* (1874) 116 Mass. 374). Payment will not be applied to debts contracted after payment (*London v. Parrott* (1899) 125 Cal. 472) nor to a future indebtedness (*Harrison v. Johnson* (1855) 27 Ala. 445) nor to demands which are not enforceable.

In case of continuous accounts, payment will be applied to the earliest, if there is no express direction or inference to the contrary (*Winnebago Paper Mills v. Travis* (1894) 56 Minn. 480). This point was settled more than a century ago when Justice Story, in *United States v. Kirkpatrick* (1824) 9 Wheat. (U. S.) 720, said:

"In cases . . . of long and running accounts, where debts and credits are perpetually accruing, and no balances are otherwise adjusted than for the mere purpose of making rests, we are of the opinion, that payments ought to be applied to extinguish the debts according to the priority of time: so that the credits are to be deemed payments pro tanto of the debts antecedently due."

Application will not usually be made to disputed items (*Banner Grain Company v. Burr Farmers' Elevator* (1925) 162 Minn. 334). Where some of the items are illegal, payment will be applied to the earliest legal items.

If there is no evidence to the contrary, and the amount paid by the debtor is exactly equal to one of the several debts, there are decisions to the effect that the jury may infer that the debtor intends that the money be applied to that obligation (*Seymour v. Van Slyck*, 8 Wend. (N. Y.) 403). Whether the debts are of a higher or a lower order makes no difference in application of payments to them. (*Pennypacker v. Umberger* (1854) 22 Pa. 492). For example, if one debt is a specialty and the others are simple contracts, all will be treated alike in respect to order of payment when the court applies. If the simple contracts were prior to the specialty they will be paid before the specialty. Priority is the determining factor, while dignity of the contract is ignored.

If the creditor of an old firm continues his business with a new partnership which has taken over the business of the old one, payments will be applied to the old debt, unless a different intention of the debtor can be proved. If a firm creditor is also creditor to a partner, a payment by a partner of partnership funds should be applied to the partnership debts in preference to the partner's personal obligations (*Codman v. Armstrong* (1848) 28 Maine 91).

Where interest is due on any account, the courts will use the payment to settle the interest, and, if there is anything left, it will be applied upon the principal of the debt (*Sheppard v. New York* (1915) 216 N. Y. 251; *Jacobs v. Ballenger* (1891) 130 Ind. 231). If there are several debts of the same degree, all carrying interest, a general payment will be applied to all of the interest before reducing the principal of any one of the obligations. In *Steele v. Taylor* (1836) 4 Dana (Ky.) 445, the court said:

“When a debtor fails to make a prompt payment of his debt, the law has fixed a rate of interest that he shall pay, as a reasonable compensation to the creditor for the delay. And, as interest will not bear interest, though it be as justly due as the principal, the creditor is deprived of the use of the interest without compensation for it. It is, therefore, just and equitable, when the credit is left to be applied by the chancellor, that it should be first applied to the extinguishment of the whole interest, or that portion of the fund, which is withheld by the debtor, that draws no interest.”

Let us summarize. The debtor has the right to direct the application of a voluntary payment; if he fails to use this right, it passes to the creditor, who, with certain restrictions, may apply the money as he thinks best. If both the debtor and the creditor fail to indicate their intention in respect to the appropriation, the court will take over the right and will apply the payment according to its idea of justice.

# Accounting for Golf and Country Clubs

BY JOSEPH SHARPLES

Every member of a golf or country club knows that at the annual meeting he is presented with a summary of the financial transactions for the year past and, possibly, a budget of financial expectations for the year to come, but seldom do many members remember that behind all this there should be an accounting system designed to facilitate the presentation of accounts in such a way as to be intelligible to all concerned, whether those be the various committees that exercise control over the different phases of the operations or the members as a whole who, once each year, meet to receive the good or bad news, as the case may be.

Activities of golf or country clubs vary from those where golf alone prevails to those in which various features of recreation and entertainment are provided for the benefit of the members and their friends. As it is in the latter form of club that the accounting system will be more extensive and present a greater degree of interest, this article will be devoted to that type of organization.

## ORGANIZATION

It has been my experience that, in those instances where the organization actually takes title to the property on which the activities are to be centered, the usual procedure is to form two separate companies, one, sometimes known as a leasing corporation, to acquire the land, lay out the golf course and erect and equip the club house, caddy house, swimming pool, tennis courts, etc., and the other, sometimes known as a golf or country club, to acquire the movable equipment, furniture, draperies, tennis nets, etc., and to operate the entire property for the benefit of the members and their guests. It is customary for the leasing corporation to lease its property to the golf or country club for a rental which is designed to cover only the actual expense of the leasing corporation, such as interest, taxes, depreciation, etc.

## FINANCING

The financing of the leasing corporation is accomplished by mortgage loans and by the sale of its capital stock. The sale is usually restricted to the members of the golf or country club and, vice versa, there is usually a condition that members of the club

must take a certain number of shares of the capital stock of the leasing corporation.

The policy of the organization usually provides that the earlier members be admitted on condition that, in addition to payment of the regular annual club dues, they acquire a stated number of shares in the leasing corporation, at a stated price, and also that later members, in addition, be required to pay to the club an initiation fee designed to cover the increased value of a membership in the organization at the time of their admission as members.

The income of the golf or country club comprises initiation fees, annual club dues and locker rentals, guests' greens fees, tennis and swimming charges and also any excess revenue that may be derived from the operation of the restaurant and the letting of rooms for private parties, etc.

#### MANAGEMENT

In outlining an accounting system it will be necessary to consider the methods of management that will be in force in controlling the various activities.

Form A (page 184) shows an organization chart of a club in which the control is vested in a board of governors or directors who in turn delegate the supervision of the various activities to certain committees and/or individuals along the following lines:

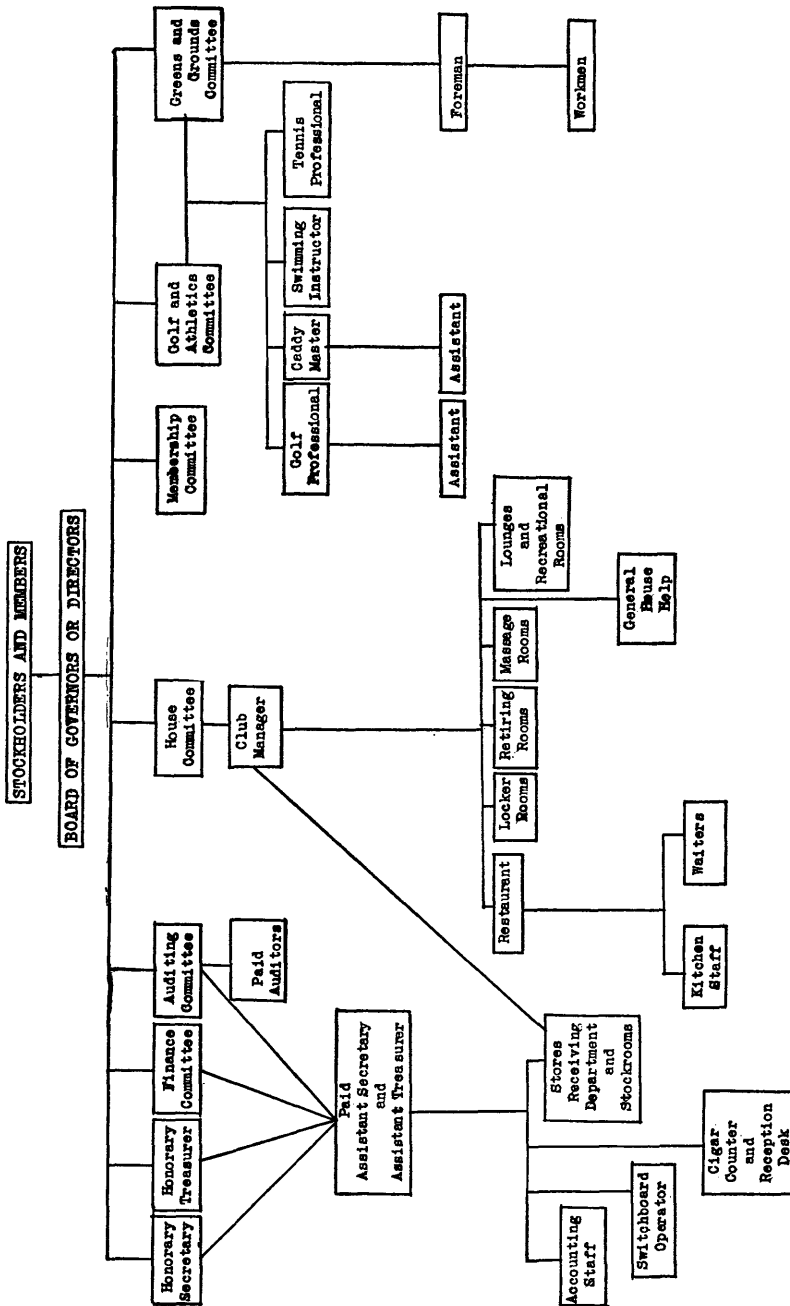
House committee—to supervise all arrangements within the club house, comprising the restaurant, locker rooms, retiring rooms, massage rooms and lounges.

Membership committee—to supervise all arrangements for the securing of new members, the disposal of the stock interest of retiring members and the dissemination of news of general interest such as the publication of monthly bulletins, etc., to all the members.

Golf and athletics committee—to supervise all arrangements for the enjoyment of the athletic and other outdoor facilities, formulation of rules for the use of the grounds, arrangements for various competitions and special events, solicitation of prize funds from the members, purchase of prizes, arrangements for caddies, etc.

Greens and grounds committee—to supervise the upkeep of the golf course, swimming pool, tennis courts and lawns, etc.

Finance committee—to advise the board of governors or directors upon the financial affairs of the organization, which



Form "A"—Organization Chart

would include the determination of the amounts of annual dues, locker rents, greens fees, swimming and tennis fees and the budgeting of expenditures to be made therefrom.

Auditing committee—to supervise all matters relating to the checking and verification of the accounts, arrange with independent auditors to conduct periodical examinations of the general accounts, receive reports from the auditors and advise the board of governors or directors of matters which should be brought to their attention.

Honorary treasurer—to be responsible for the correct recording of the various financial transactions of the organization, carry out the suggestions made through the finance committee and also put into effect any recommendations made through the auditing committee.

Honorary secretary—to be responsible for all the correspondence of the club other than that which comes directly within the province of the various committees, to keep the minutes of all meetings of the board of governors or directors and of the annual and special meetings of the members.

#### OUTLINE OF ACCOUNTS

In attempting to give a clear but condensed outline of the essential features of an accounting system for the type of organization under consideration, I shall take the accounts presented at the annual meeting and trace the steps to be followed in reaching the results.

Form B (page 188) gives a form of balance-sheet which combines the assets and liabilities of the leasing corporation with those of the golf or country club.

Forms C and D (pages 189-190) give forms of operating statements which also combine the operating results of the leasing corporation with those of the golf or country club.

The items shown in these statements will be taken from trial balances of the general ledgers of both companies.

The subsidiary records will comprise the following:

- (1) A purchase book or invoice register, in customary form, with sufficient columns in which to analyze the invoices for purchases or expenditures in order to provide for the information required on forms C and D.
- (2) A cashbook which, on the receipts side, would provide for analysis columns headed members'-charges ledger, members'-dues ledger, initiation fees, war tax, and



sundries and, on the disbursements side, analysis columns headed accounts payable, discount, and sundries.

- (3) A journal, of simple form, to be used for recording depreciation, insurance accruals, monthly inventories of restaurant and other supplies, estimated board of employees, accrual of the monthly proportion of members' dues and locker rentals, as well as other miscellaneous adjustments.
- (4) A members'-dues ledger in which will be recorded the quarterly, semi-annual or annual dues chargeable to each member.
- (5) A members'-charges ledger in which will be assembled and recorded the financial amounts of the various charge vouchers signed by the members for restaurant charges, guests' greens fees, professional charges, cigars, etc. It is usually the practice to insist, as far as possible, that no cash transactions be allowed in the club but that the members be billed monthly with all charges for their account.
- (6) A stock ledger, for the leasing corporation, to show the stock interest taken out by each club member and the progress of the payment for that interest. Sometimes new members are allowed to pay for their stock interest by monthly instalments extending over a period of one year, with interest chargeable on outstanding amounts.

#### INTERNAL CHECK

It is my experience that too much emphasis can not be placed upon the system of internal check to be enforced with respect to the various expenditures of an organization of this type. Without proper supervision and control there is usually ample opportunity for wasteful expenditure. No matter how good may be the intentions of the members of the various committees, their personal or private interests are frequently so compelling that they are not able to give all the time necessary for the complete performance of their committee work. In consequence, it is often found that a large part of the important work in relation to the financial accounts of a club is left solely in the hands of the employees.

The following is a brief outline of the procedure recommended as a measure of safeguard in various operations:

- (1) There should be a specially designated delivery or service entrance at which all deliveries of food supplies and general merchandise should be received. All receipts should be immediately weighed, counted or inspected

and the details entered in a merchandise-receiving book (sometimes known as a stewards' receiving book) in chronological order. When invoices are received they should be checked off to the receiving book and the latter should be marked in some agreed way to avoid the possibility of a duplication of invoices. The invoices should be kept on the voucher system or be stamped with a rubber stamp providing for the filling in of information concerning the date of receipt of merchandise, the correctness of the pricing and calculations, the distribution according to the accounting classifications and the approval for payment by the chairman of the committee or other responsible person.

- (2) All incoming mail should be opened by the secretary or the treasurer or by an employee designated by them, that employee should be under periodical supervision, and all cheques received should be carefully classified and listed, entered in the cashbook and banked daily.
- (3) All meals served in the restaurant or bar should be carefully controlled. This can usually be accomplished by the use of duplicate waiters' checks or charge tickets in serial numbers. In those cases where the members sign for their meals, etc., a systematic control should be kept to see that all the charge tickets are accounted for each month by debits to the individual members' accounts, for monthly billing.
- (4) Proper record should be kept of all meals served to employees, supervision made of the quantity and quality of the meals so served and care taken to see that the estimated cost of such meals is allocated to the proper department under the accounting system.
- (5) Careful control should be exercised over the various stores of food, cutlery, crockery, linen and supplies, as experience has shown that herein lies an important source of waste. Where the volume of transactions justifies such a procedure, it is sometimes advisable to employ a central storekeeper to have full charge of all merchandise received. Issues of food, beverages, cutlery, crockery, linen and other supplies would then be made to the various departments only on production of specific requisitions signed by the chef, lockerman, etc., and approved by the club manager or other person designated by the board of governors or directors.
- (6) A ticket system should be in force to control the charges for such items as guests' greens fees, swimming and tennis fees, room and garage rents, etc.
- (7) Members' dues and locker rents should be carefully supervised to see that proper charges are being made in

all cases. A register of members should be kept, the changes in which would be governed by the minutes of the board of governors or directors. Reference to this and also an actual check of the lockers in use will afford a measure of control over the income from these sources.

#### BUDGETING FOR INCOME AND EXPENDITURES

At the close of each fiscal year it is usually the duty of the finance committee to prepare a budget or estimate of the income and expenditures expected for the coming year. This budget is usually presented at the annual meeting for the approval of the members and is used, as shown in form C, as an informative guide in the preparation of the monthly and annual statements of accounts.

#### CONCLUSION

As stated previously, this article has been confined to a brief outline of the accounting requirements of a golf or country club. No attempt has been made to cover all the problems that will arise from time to time in the management of such a club. It is felt, however, that the preparation of the kind of statements suggested in this article can be accomplished without much difficulty and the information disclosed therein will usually be all that is reasonably required in club accounting.

BALANCE-SHEET AS AT.....		Form "B"	
<i>Assets</i>	Leasing corporation	Golf or country club	Total
Land and improvements.....	\$		\$
Club house and other buildings. \$			\$
Less—Depreciation reserve...			
Furniture, fittings and equipment		\$	\$
Less—Depreciation reserve...		\$	
Cash in bank and on hand.....			
Due from members:			
Stock subscriptions.....			\$
House charges.....			
Initiation fees.....			
Dues.....			
Miscellaneous.....			
Inventories of food and supplies			
Prepaid expenses.....			
<hr/>			
<i>Liabilities</i>			
Capital stock.....	\$	\$	
Mortgages.....			

## Accounting for Golf and Country Clubs

BALANCE-SHEET AS AT.....			Form "B"
Assets	Leasing corporation	Golf or country club	Total
Bank loans.....			
Accounts payable and accrued expenses.....			
Members' dues, etc. in advance.			
Surplus:			
Balance at.....	\$	\$	\$
Excess of income over expenditures—form "C".....			
	<u>\$</u>	<u>\$</u>	<u>\$</u>

STATEMENT OF OPERATIONS				Form "C"
For the periods.....				
	Budget estimate	— months ended 19	— months ended 19	
Golf or country club:				
Income:				
Members' dues.....	\$	\$	\$	
Initiation and transfer fees....				
Locker rentals.....				
Guests' greens fees.....				
Swimming fees.....				
Tennis fees.....				
Interest received.....				
Operating departments—Form D:.....				
Restaurant.....		\$	\$	
Bar.....				
Cigars and candy.....				
Room and garage rentals .....				
Total Income.....	\$	\$	\$	
Expenditures:				
House committee.....	\$	\$	\$	
Locker rooms.....				
Membership committee.....				
Golf and athletics committee....				
Greens and grounds committee...				
Administrative and general.....				
Rental to leasing corporation.....				
Total expenditures.....	\$	\$	\$	
Excess of income over expenditures—To Form B:.....		\$	\$	
Leasing corporation:				
Income:				
Rental from golf or country club.	\$	\$	\$	
Interest received.....				
Total income.....	\$	\$	\$	

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Expenditures:			
Interest on mortgage.....	\$	\$	\$
Property taxes.....			
Depreciation.....			
Total expenditures.....	\$	\$	\$
Excess of income over expenditures—To Form B:.....		\$	\$

## STATEMENT OF OPERATIONS For the period .....

Form "D"

	Restaurant	Bar	Cigars and candy
Sales.....	\$	\$	\$
Board of employees.....			
	\$	\$	\$
Cost of food, etc., consumed.....	\$	\$	\$
Gross profit.....	\$	\$	\$
Wages.....	\$	\$	\$
Supplies.....			
Ice.....			
Fuel and light.....			
Laundry.....			
Repairs and replacements.....			
Board of employees.....			
Depreciation of equipment.....			
Miscellaneous.....			
	\$	\$	\$
Net profit—per form "C".....	\$	\$	\$

	House commit- tee	Locker rooms	Member- ship committee	Golf and athletics committee	Greens and grounds committee	Adminis- trative and general
Salaries.....	\$	\$	\$	\$	\$	\$
Wages.....						
Board of employees.....						
Supplies.....						
Laundry.....						
Fuel and light.....						
Water.....						
Repairs and replacements						
Horse feed.....						
Seed and fertilizer.....						
Stationery and printing..						
Postage.....						
Depreciation.....						
Miscellaneous.....						
Per form "C".....	\$	\$	\$	\$	\$	\$

## Accounting in U. S. S. R.

BY V. A. DIAKONOFF

In my previous article (see THE JOURNAL OF ACCOUNTANCY, July, 1929) I gave a general outline of accounting here. Now I am about to relate some new stories of our profession with reference to recent developments and changes of economic life in U. S. S. R.

There have been two most important reforms that changed the external appearance of soviet balance-sheets and affected the very procedure of accounting.

I bear in mind:

- (a) The splitting-up of the heretofore single balance-sheet into two balance-sheets, viz., the exploitation balance-sheet and the construction balance-sheet.
- (b) the credit reform, which has eliminated the bill of exchange and simplified main business transactions between every two parties concerned by doing away with opening and keeping current accounts.

### THE TWO BALANCE-SHEETS

The old balance-sheet has lost its part that dealt with creation of "capital assets." Certain other assets as well as liabilities have been transferred to the "construction balance-sheet" to form a separate systematic accounting for the values entrusted to it for "creation" purposes.

Thus the exploitation balance-sheet has the assets and liabilities reflecting the main activity of the enterprise—the production of goods or services (or the distribution of them) as the case may be. All subsidiary departments and shops, power plants, transportation facilities, etc., are usually left in the operating balance-sheet, unless those shops, etc., belong as a rule to the construction organization.

The construction balance-sheet is quite independent from the operating balance-sheet, but it has no capital account of its own. Instead it has a liability to the head office for all financing received therefrom to be accounted for. This liability account we call a construction financing account. In fact it is an "account payable" for the construction balance-sheet and an "account receivable" for the head office (on its construction balance-sheet, too).

Of course, there are other local liabilities recorded in the construction balance-sheet of the enterprise among which there is a regular liability to the exploitation balance-sheet for all values and services received by one from the other.

Thus the head office—be it a “trust” (local regional administration managing affairs of a group of enterprises) or the central board of the whole branch of industry in question itself—does also keep the two balance-sheets, accurately recording thereon all the pertinent transactions and showing to the government at any given moment the extent of construction in progress.

As soon as a building or a plant, or even a single structure, is ready to enter the exploitation body of an enterprise, the “production” account (in the construction balance-sheet) is credited and an asset account called “completed features” is debited, to receive the value of such “finished product.” Further, upon receipt of the structure by the exploitation people, all formalities being over, there is a settlement performed by the enterprise.

The “head office construction financing” account is then charged with the value of the structure in question and the sum is cleared off the construction balance-sheet of the enterprise.

At the end of the fiscal year all miscellaneous indebtedness of construction balance-sheet to the exploitation balance-sheet is liquidated through the head office.

As in fact there are permanent construction, extension and capital improvements going on all over the U. S. S. R. the two balance-sheets always remain within the scope and care of the accountant’s work, splitting up his mental strain and his daily worries.

Of course, a purely constructive enterprise has only one balance-sheet with ordinary appearance. The “production” (or work in progress) account is thus charged with the values of all material and equipment necessary to build up the structure. The settlement is made in the usual way (through the state bank, see “The credit reform” below) and only construction balance-sheets are charged and credited.

The settlement for the value of a structure built by the same enterprise for its own exploitation needs, however, to be registered not only in the two balance-sheets of the enterprise but in the balance-sheet of the head office also.

The entries in question are as follows:

- (1) The first entry, that of charging the value of the structure built to the head office has been dealt with above.



(2) The head office makes the following entries:

(a) Dr. "Exploitation balance-sheet account." To transfer the amount from one balance-sheet to the other.

Cr. "Construction financing account" (of particular enterprise). To credit it for the value of structure built. This entry is made in the head office construction balance-sheet.

(b) Dr. "Enterprise N" investment account. To charge the enterprise for the value of structure received for its operation needs.

Cr. Construction balance-sheet account. To credit this balance-sheet for the value of structure built and handed over to the exploitation part of the enterprise.

The latter entry is made in the head office exploitation balance-sheet.

(3) The exploitation balance-sheet makes an entry debiting property account and crediting "head office investment account" for the value of the structure in question.

There are a good many other accounting problems involved and solved with the existence of the two balance-sheets, but I shall not go further in this direction at present.

#### THE CREDIT REFORM

Starting on October 1, 1929, the industrial coöperative unions began a new practice of settling their accounts through the state bank instead of opening credit or issuing bills of exchange to one another.

On April 1, 1930, this practice was ordered by the supreme council of national economy to be the regular and only way of making such settlements by all industries of U. S. S. R.

Prior to this arrangement a change in administration and formation of industrial units took place. Under this regulation all enterprises have been re-grouped and the head offices of particular lines of trade have been organized combining duties of the regulating, supplying and selling bodies. Thus those central head offices now have special departments supplying the enterprises with all material and equipment they need, as well as disposing of the finished products which the enterprises produce.

By virtue of a special governmental decree of January 30th and a joint law of February 24, 1930, issued by the state bank and

the supreme council of national economy, all industrial head offices have begun signing special agreements with the bank wherein it has been provided that the bank undertakes:

- (a) To settle the accounts between the enterprises and their head offices for the value of goods shipped to the latter or to their order;
- (b) To settle the accounts between the enterprises and their head offices for the value of material and equipment supplied by the head offices to their enterprises;
- (c) To settle the accounts between head offices and their customers (soviet establishment only) for the value of goods sold to the latter;
- (d) To pay head offices' debts for the purchases they make.
- (e) To finance the head offices and their enterprises according to their operating and construction programmes and financial plans.

Thus all basic transactions of every enterprise and its head office are now being done without any bill of exchange or open credit accounts. All those innumerable and responsible operations and accounting manipulations involved in the old credit system are now eliminated. All enterprises present to the state bank their operating and construction programmes, together with balance-sheets reflecting their financial position, as well as the nature of their assets, which are now considered to belong to the bank.

Thus the state bank has become not only a "clearing house" but an actual and severe comptroller of industrial affairs. It has to look after overdrafts and timely fulfilment of the planned financial and production programmes of every branch of soviet industry.

As soon as the enterprise has shipped the goods according to the direction of the head office, it presents supporting documents to the local branch of the bank and its current account with that branch is immediately credited "as per invoice." The supporting documents are then sent to the other branch of the bank, where the particular head office of the enterprise is located and this latter branch charges head-office current account. The supporting documents are now sent over to this head office with a debit note to that effect (showing also the balance of the account to date).

When a reverse case takes place, i.e., when the latter gets its material and equipment from the former, the whole procedure goes the same way, but in an opposite direction—from head office to the enterprise.

Of course, it is not necessary that the goods of the enterprise should go direct and only to the warehouses of the head office. And not all material and equipment are shipped to the enterprise from head-office warehouses only. All modern practices of through shipments direct from actual suppliers and to actual consumers are maintained in all cases where the central head office plays the part of an intermediary or of a regulating body. In those cases credits due to the selling organization and charged to the purchasing enterprise are made direct through local branch office of the state bank and the head office gets copy of the invoice for its regulating and planning needs.

Should any claims arise from these transactions such claims are subject to acceptance prior to their presentation to the bank for collection.

Now there comes a problem of *cost and profit*.

The supreme council's act 1144 of April, 1930, provides for a "settlement price" to be introduced in all transactions between an independent enterprise (i.e., with its own balance-sheet and a current account with the state bank) and its head office, instead of using actual cost which may or may not be known at the moment of shipment.

The "settlement price" is based upon the estimated cost according to financial and operating plans of the enterprise. It is predetermined at the beginning of the fiscal year and the difference between it and the actual cost of the article produced forms either profit or deficit as the case may be.

This difference is understood to be the production result and appears as debit or credit balance of a special account called "order execution account." The idea is that every production is only made upon specific orders and plans outlined by the head office and bearing the estimated or plan cost—the settlement price of the article. When the sales are made to the head office for its further disposal of the merchandise, the enterprise charges the head office with that "settlement" price and value of the goods shipped. If, however, the sales are made to the customers direct, two prices and values are shown on the duplicate invoice forwarded through the bank to the head office: the "settlement"

and the selling values. The bank credits the enterprise with the selling value and debits the purchaser. At the same time, the difference between selling and "settlement" values is credited to head office (through the respective branch office of the bank) and charged back to the enterprise. Thus the difference accumulates in favor of the head office, making a sum of gross profit collected on local operations of the enterprise. The recent developments of these transactions have led to a new practice of making transfer of the difference every ten days instead of constant charging and crediting. These lump sums of difference are wanted by the head office for its financial operations.

In some industries, however, there is no possibility of local sales made by the enterprises. Very often sales are made in a centralized way through a chain of head office warehouses spread over the whole vast area of this union. Then it is arranged that the enterprises ship their entire output to certain regional offices of the selling department of the head office without charging those offices for the cost of goods. The gross profit is then computed by the selling department and the warehouses only report the quantity of goods received as well as the quantity and value of goods sold.

To regulate all financial and trading operations of a head office and its enterprises the bank keeps two current accounts for them—one for exploitation turnover and another for construction operations. Now that the main items of monetary transactions are eliminated, i.e., the purchases and sales are made without cash or bill of exchange, leaving cheques to cover payments up to 1,000 roubles, the sum of money needed by the head office and its enterprises to pay labor, traveling expenses and other charges of miscellaneous character is comparatively small and is being given at certain intervals according to financial plan and production programme.

Let us now refer to the accounting problems and technique arising from the credit reform.

First of all, we must conceive the enormous economy in forces and time as well as the enlightenment produced by elimination of main accounting trouble in keeping, settling and adjusting transactions that used to be recorded in accounts receivable and payable, as well as notes receivable and payable.

The first group of accounts does still exist in our balance-sheet but it is reduced to record special transactions only—mostly

export and import rights and obligations as well as accounts with outsiders covering petty and occasional operations. Such small accounts may all be called "sundry debtors and creditors."

Next comes elimination of "mutual settlements account" between the head office and the enterprise as all their financial transactions are now made through the bank only. Of course, there are yet old unliquidated balances left over from the old way of accounting, but they were to be liquidated by October 1, 1930. All fresh transactions, after the credit reform has been effected in a particular industry or in its local enterprises, are now conducted through the bank.

Now, apart from "purchase and sale" operations, as well as other monetary transactions for various services, etc., let us review a number of "through" transactions of various accounting origins.

There is, for instance, "amortization" (the equivalent of American "depreciation") fund, to be now recorded as belonging to the head office and not to the enterprise. This amortization fund, unlike your "depreciation reserve" is not only an item offsetting in part the value of the property and other depreciable assets. It is a regular "capital" account to be charged for the cost of "capital repairs," renewals and the like done to the property in question. It is, therefore, a source of financing capital expenditure and is accumulated in the head offices' balance-sheets.

This fund, or capital, is now to be periodically transferred to head-office account and this transfer is also made through the bank, the entry involved being:

Dr. Amortization account (an item of factory costs).

Cr. State bank account (for account of the head office).

Such an entry is made by all industries where there are no more "trusts" as intermediaries between the enterprises and the head office. If such trusts are left as an administrative necessity, owing to special geographical and economic conditions of a particular industry, they obtain the rights and accounting prerogatives of a head office.

But as the central head office has now the only right to regulate financial matters and assignments the trust must transfer the amortization fund to its central head office. The matter is being settled in this way: The trust shows the amortization fund in its balance-sheet as accumulated from the transfers made by

the enterprises through the bank. The trust, in its turn, transfers the equivalent of this fund to the head office, but without touching the amortization-fund account, which remains on the liability side of its balance-sheet for statistical purposes. Instead of charging this account for the transfers, the trust charges head-office account thus creating a temporary and contingent asset, and credits state bank. The latter credits head office for the amortization money and the head office credits trust's account, also forming a temporary and contingent liability on its balance-sheet. When periodical consolidation of balance-sheets takes place at the central head office those mutual open accounts are cancelled out as having equal balances and the amortization-fund account appears on the consolidated balance-sheet in a summarized total. As a matter of fact only exploitation amortization is transferred to central head office. The amortization of construction assets remains in the balance-sheet of the enterprise and its amount is deducted by the head office from periodical assignments made for construction purposes.

Other transactions, such as transfers of property from one enterprise to another, as well as of various other amounts for accounting regulation, are not made through the bank inasmuch as the investment account is concerned. Its increases and decreases are not of a financial nature and no bank's control is necessary here.

To close I must dwell a little upon the recent developments in the matter of preparing yearly accounts.

Up to recently the existence of two balance-sheets threatened to produce a complication in preparing the yearly accounts and statements. The trouble was that a construction enterprise had to close its fiscal year as of the first of January, whereas the exploitation enterprises used to prepare their yearly balance-sheets as of the first of October. This fact prevented the balance-sheets from being made simultaneously and many inconveniences could arise out of this conflict.

Luckily for our profession, the governmental decree of September 20, 1930, completely eliminated this trouble. It was decided on that date that the financial year be commenced on January 1st now that the country is under permanent industrial construction, instead of being a purely agricultural one as heretofore. Thus the two balance-sheets can now be prepared and printed simultaneously on one sheet of paper in two adjoining columns.

The last quarter of the calendar year 1930 was ordered to be a special economic and accounting period with its own plans, estimates and balance-sheet.

This change of date for starting and closing the fiscal year involved another complication for the accountant, however. In order to make a comparison of the forthcoming—1931—year with the previous year, it is now necessary to prepare yearly accounts for the 1930 calendar year, which had not existed on our books. According to act 2079 of the supreme council of national economy, dated September 24, 1930, there are three balance-sheets (with certain detailed forms and statements) to be prepared; viz:

- (1) For the period of twelve months beginning October 1, 1920, and ending September 30, 1930—the old “business” year.
- (2) For that special quarter—October–December, 1930.
- (3) For the whole calendar year of 1930, beginning January 1st and ending December 31st.

It should be mentioned, by the way, that the new forms of yearly accounts introduced now are entirely different from those we have had before. Over 50 per cent. of those new forms (out of 46 in all) are to be filled by economists and statisticians and should reflect technical and economic factors of factory life for those three periods. The accounting group of forms includes those that throw light upon output and cost, capital expenditure, sales and results, as well as upon financial position of the enterprise as usual.



## Students' Department

H. P. BAUMANN, *Editor*

[NOTE.—The fact that these solutions appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official solutions of the board of examiners. They represent merely the opinions of the editor of the *Students' Department*.]

### EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

November 14, 1930, 1 P. M. to 6 P. M.

*The candidate must answer all the following questions:*

No. 1 (30 points):

Following are the balance-sheets of company A and its subsidiaries B and C as at December 31, 1929:

<i>Assets</i>	A	Companies B	C
<b>Investments:</b>			
Preferred capital stock of company B—60%.....	\$ 300,000		
Common capital stock of company B—90%.....	800,000		
Common capital stock of company C—90%.....	1,300,000		
Bonds of company B at cost.....	270,000		
Notes receivable—company B.....	20,000		
Other assets.....	2,000,000	\$2,180,000	\$2,000,000
	<u>\$4,690,000</u>	<u>\$2,180,000</u>	<u>\$2,000,000</u>
 <i>Liabilities</i>			
<b>Capital stock:</b>			
Preferred—6%.....	\$ 500,000	\$ 500,000	\$ 500,000
Common.....	1,100,000	150,000	500,000
	<u>\$1,600,000</u>	<u>\$ 650,000</u>	<u>\$1,000,000</u>
 <b>Surplus:</b>			
Balance—January 1, 1929.....	\$1,100,000	\$ 150,000	\$ 300,000
Net profits for the year 1929.....	400,000	200,000	300,000
	<u>\$1,500,000</u>	<u>\$ 350,000</u>	<u>\$ 600,000</u>
Dividends deducted.....	12,000	30,000	30,000
	<u>\$1,488,000</u>	<u>\$ 320,000</u>	<u>\$ 570,000</u>
Balance—December 31, 1929.....	\$1,488,000	\$ 320,000	\$ 570,000
First mtge., 6%, bonds outstanding.....	\$1,000,000	\$ 600,000	
Notes receivable discounted—company B..	10,000		
Notes payable—company A.....		20,000	
Other liabilities.....	592,000	590,000	\$ 430,000
	<u>\$4,690,000</u>	<u>\$2,180,000</u>	<u>\$2,000,000</u>

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The dividends on the preferred stocks of the respective companies have all been paid during the year 1929.

The bonds of company B, which mature December 31, 1936, were acquired by company A on July 1, 1929, at 90.

Company A acquired its holdings of the stock in companies B and C at the date of their incorporation and has taken up its share of the surplus and earnings of these companies.

From the foregoing, prepare a consolidated balance-sheet as at December 31, 1929, showing surplus at the beginning and end of the year, dividends paid and net profit.

### *Solution:*

The problem states that the dividends on the preferred stock of the respective companies were paid during the year 1929. As the balance-sheet of company A shows a charge against surplus account for dividends of only \$12,000, while the dividend requirement on its \$500,000 of outstanding 6 per cent. preferred stock would amount to \$30,000, it may safely be assumed that the difference, \$18,000, represents the dividend which Company A received on the \$300,000 of preferred stock of Company B owned by Company A. Apparently no dividends were paid on the common stock of any of the companies.

Nothing to the contrary, it is assumed that the preferred stock of Company B has neither cumulative dividends in arrears nor participation rights. Hence, no division of surplus between the two classes of stock is made.

### COMMENTS ON ELIMINATIONS

The par value of the bonds of Company B purchased by Company A on July 1, 1929, at 90 is shown as an elimination (A) in the working papers. For consolidated balance-sheet purposes, however, these bonds are shown as treasury bonds. The unamortized bond discount on the bonds should be reduced by a charge for the six months period during which Company A held them and a credit to its earnings. As the bonds had a life of seven and a half years at the date of purchase, the amount of the bond discount applicable to the half year ended December 31, 1929, would be 1/15 of \$30,000 or \$2,000. The balance in the unamortized discount account is shown in the consolidated balance-sheet as a deferred credit to be written off over the life of the bonds.

As Company A followed the practice of taking up its share of the profits of its subsidiaries, the book value at December 31, 1929, is eliminated from the investment accounts.

Notes receivable discounted—Company B—are carried out as a direct liability on the consolidated balance-sheet.

### COMPANY A AND ITS SUBSIDIARIES, COMPANIES B AND C

#### Consolidated balance-sheet, December 31, 1929

<i>Assets</i>	
Other assets .....	\$6,180,000
Goodwill .....	714,000
	<hr/>
	\$6,894,000
	<hr/>

COMPANY A AND ITS SUBSIDIARIES, COMPANIES B AND C  
Consolidated balance-sheet—working papers, December 31, 1929

	Companies			Eliminations		Consolidated balance-sheet
	A	B	C	Dr.	Cr.	
<i>Assets</i>						
Investments:						
Preferred capital stock of Company B—60%.....	\$ 300,000					
Eliminate book value:						
Capital stock: 60% of \$500,000.....				(E) \$ 300,000		
Common capital stock of Company B—90%.....	800,000					
Eliminate present book value:						
Capital stock: 90% of \$150,000.....				(F) 135,000		
Surplus: 90% of \$320,000.....				(G) 288,000		\$ 377,000
Goodwill.....						
Common capital stock of Company C—90%.....	1,300,000					
Eliminate present book value:						
Capital stock: 90% of \$500,000.....				(H) 450,000		
Surplus: 90% of \$570,000.....				(J) 513,000		337,000
Goodwill.....		270,000				
Bonds of Company B at cost.....					(A) 300,000	
Par.....				(B) \$ 30,000	(D) 20,000	
Unamortized bond discount.....	20,000					
Notes receivable—Company B.....	2,000,000	2,180,000	2,000,000			6,180,000
Other assets.....						
	<u>\$4,690,000</u>	<u>\$2,180,000</u>	<u>\$2,000,000</u>			<u>\$6,894,000</u>

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<i>Liabilities and net worth</i>									
<b>Capital stock:</b>									
Company A:									
Preferred.....	\$ 500,000								\$ 500,000
Common.....	1,100,000								1,100,000
Company B:									
Preferred.....		\$ 500,000							200,000 (M)
Eliminate holding company's 60% minority interest 40%.....			(E)	300,000					
Common.....		150,000							15,000 (M)
Eliminate holding company's 90% minority interest 10%.....			(F)	135,000					500,000 (M)
Company C:									
Preferred.....		\$ 500,000							50,000 (M)
Common.....		500,000							1,490,000 (S)
Eliminate holding company's 90% minority interest 10%.....			(H)	450,000					32,000 (M)
Surplus:									
Company A:									
Company A.....	1,488,000							2,000	57,000 (M)
Eliminate holding company's 90% minority interest 10%.....		320,000			(G)	288,000			1,000,000
Company C:									300,000
Company C.....		570,000			(J)	513,000			28,000
Eliminate holding company's 90% minority interest 10%.....									10,000
First mortgage 6% bonds, outstanding:									1,612,000
Company A:									
Company A.....	1,000,000								
Unamortized bond discount.....		600,000			(A)	300,000			
Notes receivable discounted—Company B.....					(C)	2,000 (B)			
Notes payable—Company A.....	10,000	20,000							
Other liabilities.....	592,000	590,000			(D)	20,000			
	<u>\$4,690,000</u>	<u>\$2,180,000</u>				<u>\$2,038,000</u>			<u>\$2,038,000</u>
									<u>\$6,894,000</u>

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<i>Liabilities and net worth</i>				
Notes payable.....				\$ 10,000
Other liabilities.....				1,612,000
First mortgage 6% bonds outstanding:				
Company A.....		\$1,000,000		
Company B.....	\$ 600,000			
Held in treasury.....	300,000	300,000		1,300,000
Unamortized bond discount.....				28,000
Minority interest:				
	<i>Company B</i>	<i>Company C</i>	<i>Together</i>	
Preferred stock—6% ....	\$200,000	\$ 500,000	\$ 700,000	
Common stock.....	15,000	50,000	65,000	
Surplus.....	32,000	57,000	89,000	
Total.....	<u>\$237,000</u>	<u>\$ 607,000</u>	<u>\$ 854,000</u>	854,000
Net Worth:				
Capital stock:				
Preferred—6%.....	\$ 500,000			
Common.....	1,100,000	\$1,600,000		
Surplus.....		1,490,000	3,090,000	
			<u>\$6,894,000</u>	

## COMPANY A AND ITS SUBSIDIARIES, COMPANIES B AND C

Analysis of consolidated surplus for the year ended December 31, 1929

Balance, January 1, 1929.....		\$1,100,000
Net profit for the year:		
Company B.....	\$200,000	
Less—Preferred stock dividends .....	30,000	
Profit applicable to common stock...	<u>\$170,000</u>	
Company A's share—90%.....		\$153,000
Company C.....	\$300,000	
Less—preferred stock dividends .....	30,000	
Profit applicable to common stock...	<u>\$270,000</u>	
Company A's share—90%.....		243,000
Total profit of subsidiaries taken up by Company A.....		\$396,000
Company A—per books.....	\$ 4,000	
Interest earned (bond discount).....	2,000	6,000
Net profits from operations.....		<u>\$402,000</u>

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Dividend received by Company A on preferred stock of Company B.....	\$18,000	\$420,000
Total.....		\$1,520,000
Dividends paid on preferred stock of Company A.....		30,000
Balance, December 31, 1929.....		\$1,490,000

### No. 2 (28 points):

The X company formed a new corporation—the Y company—and on January 1, 1930, paid \$100,000 for the entire authorized capital stock, viz.: 10,000 shares of no par value (stated value \$5 a share).

On the same date the new corporation acquired the business formerly conducted by A and B, for \$100,000 in cash. The tangible assets acquired and liabilities assumed as recorded on the books of A and B were as follows: accounts receivable, \$25,200; inventory, \$9,600; 4 per cent. bonds, par value, \$5,000; land, \$15,400; building, less depreciation, \$25,000; equipment, less depreciation, \$4,300; mortgage payable, \$15,000; accounts payable, \$25,000.

The building was purchased January 1, 1920; \$5,000 of equipment on January 1, 1919, and \$6,000 on January 1, 1928. Depreciation is said to have been recorded on a straight-line basis at the following rates: equipment, 10 per cent. per annum; building, 5 per cent. per annum to December 31, 1924, and 2½ per cent. thereafter.

The cash transactions of the Y company for the three months ended March 31, 1930, are summarized as follows:

<i>Receipts</i>	
10,000 shares of capital stock.....	\$100,000
Accounts receivable collected.....	65,000
\$3,000 par value of 4% bonds—sold February 28, 1930.....	2,800
Accrued interest on bonds sold.....	20
\$100,000 par value 5% debentures of Y company due January 31, 1940 (issued January 31, 1930).....	90,000
	<u>\$257,820</u>
<i>Disbursements</i>	
Payment to A and B.....	\$100,000
Merchandise.....	60,000
Mortgage and accounts payable at January 1, 1930.....	40,000
Selling, general and administrative expenses.....	20,000
Life-insurance premium.....	2,000
Organization expenses.....	1,500
	<u>\$223,500</u>

At March 31, 1930, accounts receivable amounted to \$80,000; accounts payable for merchandise \$35,000, for expenses \$3,000; the inventory was valued at \$40,000 and prepaid expenses were computed at \$1,000.

According to the directors' minutes, the building and equipment are to be valued for accounting purposes and recorded at cost to A and B, less depreciation on a straight-line basis at 2½ per cent. and 10 per cent. per annum respectively, and the other assets at the value shown by the books of A and B. Organization expense is to be written off in January, 1930, and depreciation is to be provided on the revised basis stated in the minutes.

Prepare balance-sheet as at March 31, 1930, including provision for federal income tax at 12 per cent., and income account for the three months ended March 31, 1930.

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### *Solution:*

The trial balance of the Y Company as at January 1, 1930, appearing in the working papers includes the outstanding capital stock of \$100,000 and goodwill of \$55,500. The goodwill figure is the excess of the \$100,000 paid in cash over the net tangible assets of A and B as recorded on the books of A and B.

The building was carried on the books of A and B at \$25,000, which amount represents the cost, less depreciation figured at 5 per cent. per annum to December 31, 1924, and 2½ per cent. thereafter. According to the minutes of the board of directors, the buildings are to be valued at cost to A and B, less depreciation on a straight-line basis at 2½ per cent. The cost of the building to A and B may be computed as follows:

Depreciation at 5%:

From January 1, 1920, to December 31, 1924

5 years at 5%..... 25 %

Depreciation at 2½%:

From January 1, 1925, to December 31, 1929

5 years at 2½%..... 12½

Total depreciation to December 31, 1929..... 37½%

Therefore—

Cost..... 100 %

Less—depreciation..... 37½

Equals book value..... 62½%, or \$25,000

The cost at January 1, 1920, was \$25,000 divided by 62½%

or..... \$40,000

The depreciation deducted was 37½% thereon or..... 15,000

And the book value was..... \$25,000

The adjustment to set up the cost of the building and the accumulated depreciation at the rate of 2½ per cent. per annum follows:

### Adjustment No. 1

Building at cost.....	\$15,000
Reserve for depreciation—building.....	\$10,000
Goodwill.....	5,000

To write up the building account to cost and to set up the reserve for depreciation on building at the annual rate of 2½% (January 1, 1920, to December 31, 1929—10 years).

The equipment account represents two purchases—one of \$5,000 made January 1, 1919, and one of \$6,000 made January 1, 1928. On the basis of a ten year life (10 per cent. depreciation per annum on cost, without allowance for scrap) the first purchase was theoretically retired one year after the date of the second purchase. An analysis of the equipment account should show:

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	First purchase		Second purchase		Net balance
	Depre- ciation	Cost	Depre- ciation	Cost	
January 1,					
1919 .....		\$5,000			\$5,000
1920 .....	\$ 500				4,500
1921 .....	500				4,000
1922 .....	500				3,500
1923 .....	500				3,000
1924 .....	500				2,500
1925 .....	500				2,000
1926 .....	500				1,500
1927 .....	500				1,000
1928 .....	500			\$6,000	6,500
1929 .....	500		\$ 600		5,400
1930 .....	500		600		4,300
Totals .....	<u>\$5,500</u>	<u>\$5,000</u>	<u>\$1,200</u>	<u>\$6,000</u>	<u>\$4,300</u>

From the above analysis it will be seen that the first purchase of \$5,000 had been charged with \$5,500 of depreciation which may be adjusted as follows:

Adjustment No. 2

Equipment .....	\$6,700	
Reserve for depreciation—equipment .....		\$6,200
Goodwill .....		500
To set up the cost of equipment, and to adjust the depreciation reserve.		

If the equipment purchased on January 1, 1919, for \$5,000 had been scrapped, it should have been written off the books by a charge to reserve for depreciation—equipment, and a credit to equipment.

The cash transactions, subsequent to the sale of the capital stock of Y Company and the payment made to A and B which are given effect to in the working trial balance, may be recorded as a journal entry.

Adjustment No. 3

Cash .....	\$34,320	
Merchandise .....	60,000	
Mortgage .....	15,000	
Accounts payable .....	25,000	
Selling, general and administrative expenses .....	20,000	
Life insurance premium .....	2,000	
Organization expense .....	1,500	
Accounts receivable .....		\$65,000
4% bonds .....		2,800
Accrued interest on bonds sold .....		20
5% debentures of Y Company .....		90,000

To record cash receipts and disbursements for the period January 1, 1930, to March 31, 1933.



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Adjustment No. 4

Loss on sale of 4% bonds.....	\$200	
4% bonds.....		\$200
To record the loss on the sale of \$3,000 par of 4% bonds.		

Adjustment No. 5

Unamortized bond discount.....	\$10,000	
5% debentures of Y Company.....		\$10,000
To record the unamortized bond discount on the \$100,000 par value of 5% debentures issued January 31, 1930, and due January 31, 1940.		

To prepare an income account it will be necessary to compute the amount of sales for the period. This can be done as follows:

Accounts receivable at March 31, 1930.....	\$ 80,000
Accounts receivable collected.....	65,000
	<hr/>
Total.....	\$145,000
Deduct—accounts receivable January 1, 1930...	25,200
	<hr/>
Balance representing sales during period.....	<u>\$119,800</u>

Adjustment No. 6

Accounts receivable.....	\$119,800	
Sales.....		\$119,800
To record sales during period from January 1, 1930, to March 31, 1930.		

Adjustment No. 7

Merchandise.....	35,000	
Accounts payable.....		35,000
To record accounts payable for merchandise as at March 31, 1930.		

Adjustment No. 8

Prepaid expenses.....	1,000	
Selling, general and administrative expenses.....	2,000	
Accounts payable—expenses.....		3,000
To record the accounts payable for expenses at March 31, 1930.		

Adjustment No. 9

Inventory—March 31, 1930.....	40,000	
Merchandise.....		40,000
To set up inventory at March 31, 1930.		

Adjustment No. 10

Depreciation—building.....	250	
Reserve for depreciation—building.....		250

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To set aside depreciation on building for the period at the rate of  $2\frac{1}{2}\%$  per annum.

Cost.....	<u>\$40,000</u>
$2\frac{1}{2}\%$ per annum.....	<u>\$ 1,000</u>
3 months.....	<u>\$ 250</u>

### Adjustment No. 11

Depreciation—equipment.....	\$ 150	
Reserve for depreciation—equipment.....		\$ 150

To set aside depreciation for the period at the rate of 10% per annum on the \$6,000 of equipment not written off. 10% of \$6,000 divided by 4=\$150.

Apparently the interest on the four per cent. bonds was collected on January 1, 1930, as the interest accrued on the \$3,000 par of bonds sold on February 28, 1930, amounted to \$20—the interest for two months on \$3,000 at 4 per cent. per annum. The interest on the \$2,000 par of 4 per cent. bonds still on hand at March 31, 1930, is, therefore,  $\frac{1}{4}$  (\$2,000×4 per cent.) or \$20. The interest earned on the bonds sold and on those still on hand should be recorded as earned.

### Adjustment No. 12

Accrued interest on bonds sold.....	\$ 20	
Accrued interest on bonds.....	20	
Interest earned.....	—	\$ 40

To record the interest earned on the bonds sold and still on hand.

Provision should be made for the accrued interest and the bond discount amortized on the \$100,000 of 5 per cent. debentures of Y Company which were issued on January 31, 1930. The accrued interest thereon at March 31, 1930, would amount to  $\frac{1}{6}$  of 5 per cent. of \$100,000 or \$833.33. The amount of bond discount to be amortized, using the straight-line method would be:

Amount of bond discount.....	<u>\$10,000.00</u>
Years outstanding—10 years.	
Annual charge.....	<u>\$ 1,000.00</u>
Applicable to two months period—January 31, 1930, to March 31, 1930.....	<u>\$ 166.67</u>

### Adjustment No. 13

Bond discount amortized.....	\$ 166.67	
Interest on debentures.....	833.33	
Accrued interest on debentures.....		\$ 833.33
Unamortized bond discount.....		166.67
To record interest charge on debentures.		

THE Y COMPANY  
Working papers for the period January 1, 1930, to March 31, 1930

	Trial balance The Y Company January 1, 1930		Adjustments		Profit and loss	Balance-sheet
	Dr.	Cr.	Dr.	Cr.		
Accounts receivable.....	\$ 25,200.00		(6) \$119,800.00	(3) \$ 65,000.00	\$ 9,600.00	\$80,000.00
Inventory—January 1, 1930.....	9,600.00			(3) 2,800.00		2,000.00
Four per cent. (4%) bonds.....	5,000.00			(4) 200.00		15,400.00
Land.....	15,400.00					40,000.00
Building.....	25,000.00		(1) 15,000.00			11,000.00
Equipment.....	4,300.00		(2) 6,700.00			
Mortgage payable.....		\$ 15,000.00	(3) 15,000.00			
Accounts payable.....		25,000.00	(7) 35,000.00			\$ 35,000.00
Capital stock—10,000 shares no par value		100,000.00		(1) 5,000.00		100,000.00
Goodwill.....	55,500.00			(2) 500.00		
Reserve for depreciation—building.....				(1) 10,000.00		50,000.00
Reserve for depreciation—equipment.....				(10) 250.00		10,250.00
Cash.....			(2) 6,200.00			6,350.00
Merchandise.....			(11) 150.00			
Selling, general and administrative ex- penses.....			(4) 40,000.00		\$ 40,000.00	34,320.00
Life insurance premium.....					95,000.00	
Organization expense.....					22,000.00	
Accrued interest on bonds sold.....					2,000.00	
Five per cent. (5%) debentures.....						100,000.00
Loss on sale of four per cent. (4%) bonds					200.00	
Unamortized bond discount.....			(3) 34,320.00			9,833.33
Sales.....			(3) 60,000.00			
Prepaid expenses.....			(7) 35,000.00			
Accounts payable—expenses.....					119,800.00	
Inventory, March 31, 1930.....						1,000.00
Depreciation—building.....						40,000.00
Depreciation—equipment.....						
Accrued interest on bonds.....						20.00
Interest earned.....						
Bond discount amortized.....						
Interest on debentures.....						
Accrued interest on debentures.....						
Surplus.....						833.33
Federal income tax.....						
Reserve for federal income taxes.....						
Net profit for the period.....						
Totals.....	\$140,000.00	\$140,000.00	\$394,256.80	\$394,256.80	\$159,840.00	\$285,073.33

## *Students' Department*

### Adjustment No. 14

Surplus .....	\$1,500.00	
Organization expense .....		\$1,500.00
To write off organization expense.		
No portion of the life insurance premium is deferred as sufficient information is not available.		

### Adjustment No. 15

Surplus .....	\$3,796.80	
Reserve for federal income taxes .....		\$3,796.80
To provide a reserve for federal income taxes for the period.		

### THE Y COMPANY

Statement of profit and loss for the period, January 1, 1930, to March 31, 1930

Sales .....			\$119,800.00
<i>Deduct</i> —cost of sales:			
Inventory, January 1, 1930 .....	\$ 9,600.00		
Purchases .....	95,000.00		
Total .....	\$104,600.00		
Inventory, March 31, 1930 .....	40,000.00	64,600.00	
Gross profit on sales .....			\$ 55,200.00
<i>Deduct</i> —expenses:			
Selling, general and administrative expenses ...	\$ 22,000.00		
Life insurance premium .....	2,000.00		
Depreciation:			
Building .....	\$250.00		
Equipment .....	150.00	400.00	24,400.00
Profit from operations .....			\$ 30,800.00
<i>Deduct</i> —net financial expenses:			
Interest paid:			
Amortization of bond discount ....	\$166.67		
Interest on debentures .....	833.33	\$ 1,000.00	
<i>Less</i> —interest earned .....		40.00	960.00
Net profit and income .....			\$ 29,840.00
Loss on sale of bonds .....	\$ 200.00		
Provision for federal income tax .....	3,796.80	3,996.80	
Net profit for the period, January 1, 1930, to March 31, 1930 .....			\$ 25,843.20

## *The Journal of Accountancy*

### Computation of federal income tax for the period January 1, 1930, to March 31, 1930

Net profit and income, per statement of profit and loss.....	\$ 29,840.00
Add—life insurance premium—(It is assumed that the corporation is the beneficiary, hence the premium is non-deductible)	2,000.00
Total.....	<u>\$ 31,840.00</u>
Deduct—loss on sale of bonds.....	200.00
Taxable income.....	<u>\$ 31,640.00</u>
Income tax for the period—12% of \$31,640.00 or.....	<u>\$ 3,796.80</u>

### THE Y COMPANY Balance-sheet—March 31, 1930

#### *Assets*

#### Current assets:

Cash.....	\$ 34,320.00
Accounts receivable.....	80,000.00
Inventory.....	40,000.00
Accrued interest receivable.....	20.00
	<u>\$154,340.00</u>

#### Investments:

Four per cent. (4%) bonds.....	2,000.00
Prepaid expenses.....	1,000.00
Unamortized bond discount.....	9,833.33

#### Fixed assets:

	Cost	Reserve for Depreciation	Balance	
Land.....	\$15,400.00		\$15,400.00	
Building.....	40,000.00	\$10,250.00	29,750.00	
Equipment.....	11,000.00	6,350.00	4,650.00	
Total.....	<u>\$66,400.00</u>	<u>\$16,600.00</u>	<u>\$49,800.00</u>	49,800.00

Goodwill.....	50,000.00
---------------	-----------

\$266,973.33

#### *Liabilities and net worth*

#### Current liabilities:

Accounts payable—merchandise.....	\$35,000.00
Accounts payable—expenses.....	3,000.00
Accrued interest payable.....	833.33
	<u>\$ 38,833.33</u>

Reserve for federal income taxes.....	3,796.80
Five per cent. (5%) debentures—due January 31, 1940.....	100,000.00

## *Students' Department*

### Net worth:

Capital stock—authorized and outstanding 10,000 shares of no par value.....	\$100,000.00		
Surplus:			
Profit for the three-months period ended March 31, 1930.....	\$25,843.20		
Less—organization expense.....	1,500.00	24,343.20	\$124,343.20
			<u>\$266,973.33</u>

### ILLINOIS C. P. A. EXAMINATION QUESTION

The following problem was set by the board of examiners in accountancy of the University of Illinois on May 15, 1930:

Following is a trial balance of the Maud N. Manufacturing Company, Chicago, a Delaware corporation, at December 31, 1929:

Account	Debit	Credit
Cash in First State Bank.....	\$ 7,209.15	
Customers' accounts.....	84,600.31	
Raw material (inventory at December 31, 1928, plus 1929 purchases).....	298,934.60	
Work in process.....	92,020.02	
Finished stock.....	66,098.50	
Unexpired insurance premiums.....	1,234.45	
Machinery and equipment.....	375,121.11	
Reserve for depreciation.....		\$ 100,240.96
Accounts payable and accrued.....		64,233.25
No-par-value common stock (20,000 shares authorized and outstanding).....		256,488.90
Earned surplus—balance, December 31, 1928.		133,082.51
Sales.....		974,016.22
Cost of sales.....	779,115.31	
Materials absorbed.....		288,854.12
Direct labor absorbed.....		209,600.44
Factory overhead absorbed.....		192,832.40
Direct labor.....	209,600.44	
Factory overhead.....	186,550.05	
Salesmen's commissions.....	85,314.48	
Officer's salary.....	20,000.00	
Office rent and expense.....	3,376.20	
Provision for federal income tax.....	10,174.18	
Totals.....	<u>\$2,219,348.80</u>	<u>\$2,219,348.80</u>

Physical inventories at cost, which were lower than market prices, were as follows:

Particulars	December 31 1928	1929
Raw materials.....	\$17,200.50	\$10,080.48
Work in process:		
Material.....	41,236.48	39,604.02
Direct labor.....	30,050.00	27,300.00
Factory overhead.....	27,646.00	25,116.00

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Finished stock:		
Material . . . . .	\$62,438.33	\$28,850.50
Direct labor . . . . .	49,650.00	19,400.00
Factory overhead . . . . .	45,678.00	17,848.00
The inventory of December 31, 1928, was sold during 1929.		
Machinery manufactured in 1929 for own use:		
Materials . . . . .		3,454.63
Labor . . . . .		3,800.68
Overhead . . . . .		3,496.63
Total capitalized . . . . .		<u>\$10,751.94</u>

Engaged in the audit of the books of the company, you find the above figures correct with the following exceptions:

(1) Factory overhead has been absorbed during 1929 on the basis of 92 per cent. of direct labor which was the correct ratio for 1928; 1929 factory overhead absorbed must be corrected by employing the actual ratio for 1929. You are to use a percentage without a decimal fraction.

(2) Depreciation expense in factory overhead includes an allowance on machinery manufactured for own use to which the excessive overhead has been added; depreciation was computed thereon at 5 per cent. (one-half the annual rate) which is the proper rate for additions made during the year. The depreciation provision must be corrected.

(3) Federal income tax at 11 per cent. must be recomputed.

Prepare, in a form suitable for inclusion in an audit report:

(a) Balance-sheet at December 31, 1929.

Statements for the year 1929 of—

(b) Profit and loss;

(c) Cost of manufacture and sales.

Prepare also (d) a schedule showing the amount of material, labor, and factory overhead appearing in the adjusted cost of sales.

## *Solution:*

Under exception (2) it is noted that the factory overhead includes a charge for depreciation at the rate of 5 per cent. on the machinery manufactured by the company during the year. In ascertaining the rate of factory overhead to direct labor for the current year, 1929, it will be necessary to consider this charge for depreciation which was based upon the cost of the machinery constructed, which cost included a provision for overhead based upon the rate for the year 1928. The following computation shows that the overhead rate for the current year is 88.746 per cent. excluding any provision for depreciation on the machinery constructed, which should not be charged for depreciation on itself, incurred subsequently to its completion. The overhead rate (including such depreciation), to be applied to cost of sales and closing inventories amounts to 88.999 per cent. As the problem states that the candidate is to use a percentage without a decimal fraction, the slight variation in the rates is not considered.

The factory overhead as stated in the trial balance dated	
December 31, 1929 amounts to . . . . .	\$186,550.05
from which is deducted the provision for depreciation on the	
machinery constructed (5% of \$10,751.94) . . . . .	537.60
which leaves a balance for overhead of . . . . .	<u>\$186,012.45</u>
or 88.746% of the direct labor amounting to . . . . .	<u>\$209,600.44</u>

## *Students' Department*

The adjusted cost of the machinery constructed may now be stated as follows:

Labor.....	\$ 3,800.68
Overhead (89% of \$3,800.68).....	3,382.61
Materials.....	3,454.63
	<hr/>
Total cost.....	\$ 10,637.92
	<hr/>

The factory overhead rate to be applied to the cost of sales, and the closing inventories of work-in-process and finished goods is determined as follows:

Direct labor per trial balance.....	\$209,600.44
Less: Direct labor charged to machinery and equipment..	3,800.68
	<hr/>
Direct labor applicable to cost of sales, and inventories...	\$205,799.76
	<hr/>
Factory overhead, per trial balance.....	\$186,550.05
Less: Adjustment for depreciation (entry No. 2) \$ 5.70	
Factory overhead charged to machinery and equipment.....	3,382.61
	<hr/>
	3,388.31
Factory overhead applicable to cost of sales, and closing inventories.....	\$183,161.74
	<hr/>
The rate of overhead to direct labor is therefore, \$183,161.74 divided by \$205,799.76 or.....	88.99 + %

### Explanatory adjusting entries.

Factory overhead absorbed.....	\$192,832.40	
Work-in-process inventory—12/31/29.....		\$ 25,116.00
Finished-goods inventory—12/31/29.....		17,848.00
Machinery and equipment.....		3,496.63
Cost of sales.....		146,371.77
To reverse the credits to the factory-overhead-absorbed account.		
Reserve for depreciation.....	5.70	
Factory overhead.....		5.70
To correct the charge for depreciation taken on the machinery and equipment constructed during the year.		
Amount provided.....	\$537.60	
Correct amount.....	531.90	
		<hr/>
Excess.....	\$ 5.70	
		<hr/>
Work in process inventory—12/31/29.....	24,297.00	
Finished goods inventory—12/31/29.....	17,266.00	
Machinery and equipment.....	3,382.61	
Cost of sales.....	141,598.74	



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Factory overhead.....		\$186,544.35
To charge the above accounts on the basis of 89% of labor.		
Accounts payable and accrued.....	\$166.02	
Provision for federal income tax.....		166.02
To correct the provision for federal income tax.		
Amount set out.....	\$10,174.18	
Corrected amount.....	10,008.16	
Excess.....	\$	<u>166.02</u>

*Exhibit A*

MAUD N. MANUFACTURING COMPANY  
Balance-sheet—December 31, 1929

<i>Current assets:</i>		<i>Assets</i>
Cash in First State Bank.....	\$	7,209.15
Customers' accounts.....		84,600.31
<i>Inventories:</i>		
Raw materials.....	\$10,080.48	
Work in process.....	91,201.02	
Finished goods.....	65,516.50	
		<u>166,798.00</u>
		\$258,607.46
Unexpired insurance premiums.....		1,234.45
Machinery and equipment.....	\$375,007.09	
Less: reserve for depreciation.....	100,235.26	274,771.83
		<u></u>
		<u>\$534,613.74</u>

*Liabilities and net worth*

<i>Current liabilities:</i>		
Accounts payable and accrued.....		\$64,067.23
<i>Net worth:</i>		
Capital stock—authorized and outstanding—20,000 shares of no-par-value.....	\$256,488.90	
<i>Surplus:</i>		
January 1, 1929.....	\$133,082.51	
Profits for the year, after pro- vision for federal income tax amounting to \$10,008.16 (ex- hibit B).....	80,975.10	
		<u>214,057.61</u>
		470,546.51
		<u>\$534,613.74</u>

*Students' Department*

*Exhibit B*

MAUD N. MANUFACTURING COMPANY

Statement of profit and loss for the year ended December 31, 1929

Sales .....	\$974,016.22
Cost of sales (exhibit C) .....	774,342.28
	<hr/>
Gross profit on sales .....	\$199,673.94
Expenses:	
Salesmen's commissions .....	\$85,314.48
Officer's salary .....	20,000.00
Office rent and expense .....	3,376.20
	<hr/>
	108,690.68
Net profit from operations .....	\$90,983.26
Federal income tax .....	10,008.16
	<hr/>
Net profit for the year after provision for federal income tax .....	<u>\$80,975.10</u>

*Exhibit C*

MAUD N. MANUFACTURING COMPANY

Statement of cost of goods manufactured and sold for the year ended December 31, 1929

Work in process—January 1, 1929 .....	\$ 98,932.48
Materials:	
Inventory, January 1, 1929 .....	\$ 17,200.50
Purchases .....	281,734.10
	<hr/>
Total .....	\$298,934.60
Deduct—	
Amount used in construction of machinery .....	\$ 3,454.63
Inventory, December 31, 1929..	10,080.48
	<hr/>
	13,535.11
Labor .....	\$209,600.44
Less amount used in construction of machinery.	3,800.68
	<hr/>
	205,799.76
Factory overhead .....	\$186,544.35
Less amount applied to machinery construction	3,382.61
	<hr/>
	183,161.74
Total manufacturing costs .....	\$773,293.47
Less: work-in-process inventory, December 31, 1929 .....	91,201.02
	<hr/>
Cost of goods manufactured .....	\$682,092.45
Add: decrease in finished-goods inventories:	
Inventory, January 1, 1929 .....	\$157,766.33
Inventory, December 31, 1929 .....	65,516.50
	<hr/>
	92,249.83
Cost of goods sold .....	<u>\$774,342.28</u>

# *The Journal of Accountancy*

## MAUD N. MANUFACTURING COMPANY

Schedule showing the amount of material, labor and factory overhead  
appearing in the adjusted cost of sales

	Raw Material	Labor	Factory Overhead	Total
<b>Inventories at January 1, 1929:</b>				
Raw material.....	\$ 17,200.50			\$ 17,200.50
Work in process.....	41,236.48	\$ 30,050.00	\$ 27,646.00	98,932.48
Finished stock.....	62,438.33	49,650.00	45,678.00	157,766.33
<b>Totals in inventories at January 1, 1929.....</b>	<b>\$120,875.31</b>	<b>\$ 79,700.00</b>	<b>\$ 73,324.00</b>	<b>\$273,899.31</b>
<b>Amounts applied to production during the year.....</b>	<b>\$281,734.10</b>	<b>\$209,600.44</b>	<b>\$186,544.35</b>	<b>\$677,878.89</b>
<b>Less: amounts applied to ma- chinery constructed.....</b>	<b>3,454.63</b>	<b>3,800.68</b>	<b>3,382.61</b>	<b>10,637.92</b>
<b>Total.....</b>	<b>\$278,279.47</b>	<b>\$205,799.76</b>	<b>\$183,161.74</b>	<b>\$667,240.97</b>
<b>Grand total.....</b>	<b>\$399,154.78</b>	<b>\$285,499.76</b>	<b>\$256,485.74</b>	<b>\$941,140.28</b>
<b>Deduct:</b>				
<b>Inventories at December 31, 1929:</b>				
Raw material.....	\$ 10,080.48			\$ 10,080.48
Work in process.....	39,604.02	\$ 27,300.00	\$ 24,297.00	91,201.02
Finished goods.....	28,850.50	19,400.00	17,266.00	65,516.50
<b>Totals in inventories at December 31, 1929.....</b>	<b>\$ 78,535.00</b>	<b>\$ 46,700.00</b>	<b>\$ 41,563.00</b>	<b>\$166,798.00</b>
<b>Amounts included in cost of sales for the year.....</b>	<b>\$320,619.78</b>	<b>\$238,799.76</b>	<b>\$214,922.74</b>	<b>\$774,342.28</b>

The factory overhead has been corrected to the adjusted rate of 89% of labor.

# Institute Examination in Law

BY SPENCER GORDON

[The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1930, have been prepared at the request of THE JOURNAL OF ACCOUNTANCY. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor, THE JOURNAL OF ACCOUNTANCY.*]

## EXAMINATION IN COMMERCIAL LAW

November 14, 1930, 9 A. M. to 12:30 P. M.

### GROUP I

*Answer all questions in this group, giving reasons for your answers.*

No. 1:

In the course of an audit you find that your client has recently purchased improved real estate. He shows you an unexpired fire-insurance policy accurately describing the buildings but payable to the former owner and not assigned or transferred to your client. He says he is fully protected because the buildings are insured and the policy "runs with the property insured." Is his statement correct?

*Answer:*

A fire-insurance policy is held to be a personal contract with the assured, insuring whatever interest he may have in the premises. Such a policy does not "run with the property insured," and sale of the property will not operate as an assignment.

No. 2:

On July 7, 1930, a stranger called at the office of Dunham, a public accountant, exhibited the card of a well-known stationery house and obtained an order for analysis paper. On the next day the analysis paper was received by Dunham, together with an invoice payable in 30 days. On July 15, 1930, the stranger called and asked Dunham whether he would pay then for the paper. Dunham paid in cash and the stranger receipted the bill. It developed that the stranger was a solicitor who received a commission on any order accepted and filled, and that he had disappeared without accounting for the collection from Dunham. Can the stationery house collect from Dunham for this paper?

*Answer:*

The stationery house can collect from Dunham. In the absence of actual authority, an agent without possession of goods sold has no power to receive payment. A buyer paying a salesman in such circumstances does so at his own risk.

No. 3:

Blair, a public accountant, rendered professional services to Jenkins without agreement in advance as to the amount of the fee. Upon completion of the work, Jenkins gave Blair his negotiable promissory note for \$2,000 payable 30 days after date, in payment for Blair's services. Two weeks thereafter Jenkins had Blair's work appraised by three disinterested experts, all of whom

agreed that the fair value of it was \$500. In an action by Blair on this note, can Jenkins successfully defend on the ground of inadequacy of consideration?

*Answer:*

Inadequacy of consideration is not a defense to a note given in payment for services, regardless of their true value, unless the note was procured by fraud. Courts will not look into the sufficiency of the consideration for which a note was given where that consideration is of indeterminate value.

No. 4:

A corporation had a deficit of \$40,000 at January 1, 1929. During that year it earned a net income from all sources amounting to \$35,000. In January, 1930, the board of directors declared a dividend of \$10,000 out of the 1929 profits. Would this dividend have been legal in your state?

*Answer:*

Dividends may be paid only from surplus. This is usually defined as the excess of assets over all liabilities, including capital stock as a liability. In such case a previous deficit must thus be made up from current profits before a fund is created from which dividends may be lawfully declared.

No. 5:

Brown, Coates and Danforth were partners sharing profits in proportions of one-fourth, one-third and five-twelfths, respectively. Their business failed and the firm was dissolved. At the time of dissolution no financial adjustments among partners were necessary but the firm's liabilities to creditors exceeded its assets by \$24,000. Without contributing any amount toward the payment of the liabilities, Coates moved to Europe, where he was not subject to legal process. Brown and Danforth are financially responsible. How much must each contribute?

*Answer:*

In the absence of specific agreement, partnership losses are apportioned as between the partners in the same proportion that profits are shared. Insolvency of any partner or removal without the jurisdiction does not change this rule; the entire loss is borne by the remaining partners in the same ratio as between them that they shared the profits. Brown and Danforth share the loss in the ratio of one-fourth to five-twelfths, or \$9,000 and \$15,000, respectively, and can recoup from each other to effect this result. As regards third party creditors, each is liable for the whole loss.

GROUP II

*Answer any five of the questions in this group, but no more than five.*

No. 6:

Curtis, a public accountant, was engaged by Black to make an audit of Black's books, at specified per-diem rates. During the course of this audit, Curtis uncovered a defalcation whereby Black saved \$25,000. After the audit was concluded and Curtis had rendered his report, Black promised to pay Curtis an additional fee of \$5,000 for uncovering the defalcation. Can Curtis hold Black to this promise?

*Answer:*

A promise must be supported by consideration to be enforceable against the promisor. Services rendered in the past under a previous contract at agreed rates are not consideration for a subsequent promise, although the services were fairly worth more than the sum agreed to be paid. Curtis can not force Black to pay the additional \$5,000.

No. 7:

Thompson gave a promissory note, endorsed by Sherwood, to Babcock. This was a demand note for \$5,000 with interest at 6 per cent. Later, without Sherwood's knowledge, Babcock made a valid agreement with Thompson reducing the interest rate to 5 per cent. Upon Thompson's failure to pay the note, Sherwood contended that he had been discharged from liability because Babcock had changed Thompson's agreement. Is his contention sound?

*Answer:*

The general rule is that any material change of a contract, binding on the principal, made without the consent of the surety thereon discharges the surety. The interest rate is a material provision of the contract, and where the suretyship is voluntary, the change discharges the surety even if non-prejudicial. The change, however, must be in the contract itself and not merely an independent agreement collateral thereto. While an actual alteration of the note would discharge the endorser, it has been held that an agreement binding on maker and payee to reduce the rate of interest is not an alteration of the contract, but a collateral agreement which will not discharge the endorser.

No. 8:

At 11:30 a. m. Shaw wired Brauer, "Subject prompt reply will engage you to make audit \$2,000 fee." Brauer received this wire at 12:16 p. m. At 12:28 p. m. Brauer wired Shaw accepting the offer. At 1 p. m. Shaw had not received Brauer's wire and Shaw wired Brauer revoking his offer. At 1:43 p. m. Shaw received Brauer's wire accepting the offer. Was there a contract?

*Answer:*

An offer sent by wire impliedly authorizes an acceptance by the same means. Such an acceptance, if made within the required time and before revocation, is effective from the moment it is given the telegraph company for transmission, and, other essentials being present, a contract results. An offer is not revoked until a revocation has been received by the offeree. Brauer's prompt acceptance of the offer, sent prior to his receipt of the revocation, completes the formation of a contract if other requirements are present.

It is essential to a contract that the nature and extent of the obligations assumed by each of the parties be certain, although it is not necessary that they be set forth in the written offer and acceptance if they are understood at the time by the parties. In the present case, if Brauer knows to what audit Shaw refers, its general nature and extent, whether from previous dealings or a knowledge of Shaw's business, then the minds of the parties have met and a contract results. If Brauer knows nothing of the audit referred to beyond what is contained in the telegram, then the incidents of the offer and acceptance are too uncertain to result in a contract.

No. 9:

Hughes was a bookkeeper for the Sutton mills, receiving his salary monthly under a contract providing that if he left without giving two weeks' notice he should receive nothing for wages accrued during the current month. On June 14, 1930, Hughes was arrested, convicted and sentenced to jail. The damage to the Sutton mills from want of notice was greater in amount than one-half of Hughes' salary for June. Can Hughes recover his salary for the period from June 1st to June 14th?

*Answer:*

Hughes can recover his salary from June 1st to 14th. A contract providing for a forfeiture of wages for leaving without notice is interpreted to mean a

voluntary leaving only, and the forfeiture will not be enforced against an employee who is arrested and imprisoned.

No. 10:

Bishop, a public accountant, desiring to retire from practice, sold all his assets including his goodwill to Palmer for a stated sum. As a part of the sale Bishop covenanted that he would not engage in the public practice of accounting anywhere for a period of ten years. Is this agreement by Bishop valid?

*Answer:*

An agreement not to engage in the public practice of a profession or trade, entered into in consideration of the sale of such business, is valid only if it constitutes a reasonable protection of the business sold. An agreement not to engage in the public practice of accounting, unlimited as to space, extends further than a reasonable protection for the business sold requires, and such agreement is invalid as being in restraint of trade.

No. 11:

C. A. Nimocks was a promoter engaged in effecting the organization of the Times Printing Company. On September 12, 1928, on behalf of the proposed corporation, he made a contract with McArthur for his services as comptroller for the period of one year beginning October 1, 1928. The Times Printing Company was incorporated October 16, 1928, and at that date McArthur commenced his duties as comptroller. No formal action with reference to his employment was taken by the board of directors or by any officer, but all the stockholders, directors and officers knew of the contract made by Nimocks. On December 1, 1928, McArthur was discharged without cause. Has he cause of action against the Times Printing Company?

*Answer:*

A contract for services, made prior to incorporation, in the name and on behalf of a proposed corporation, is held to be adopted by that corporation as of the date of incorporation if it accepts the services contracted for with full knowledge of the contract. McArthur has a cause of action against the printing company for damages for his wrongful discharge in breach of this contract.

No. 12:

Section 12 of the revenue act of 1928 provides that there shall be no surtax upon a net income of a specified amount; section 25 provides for certain credits against net income; section 22 (b) provides that certain items shall be excluded from gross income; section 23 allows certain deductions from gross income. Assume an individual's total income from all sources to be \$100,000. Using round amounts to illustrate one or more of the items covered by each of the last three sections listed above, show the computation of his net income subject to normal tax and of his net income subject to surtax (the computation of the tax is not required).

*Answer:*

An individual's total income from all sources is assumed to be \$100,000 composed of the following items:

(1) Salary .....	\$ 40,000
(2) Dividends from domestic corporations .....	20,000
(3) Interest on state obligations .....	15,000
(4) Gift (not made as consideration for service rendered) .....	10,000
(5) Rent from building .....	10,000
(6) Profit from sale of stock .....	5,000

Total income .....	\$100,000
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### *Institute Examination in Law*

Under section 22 (b), revenue act of 1928, interest on obligations of a state and gifts not made as consideration for services rendered are excluded from gross income. Total income of \$100,000 is therefore reduced by \$25,000, resulting in gross income of \$75,000.

The above taxpayer is entitled to certain deductions under section 23, revenue act of 1928. Such deductions would be as follows:

(1) Interest paid on indebtedness to carry stocks on margin . . . . .	\$ 2,000
(2) Real estate taxes paid in the sum of . . . . .	3,000
(3) Loss by fire of building, not covered by insurance, resulting in loss sustained of . . . . .	10,000
(4) Bad debt . . . . .	5,000
Total deductions . . . . .	<u>\$20,000</u>

The gross income of \$75,000 is decreased by deductions of \$20,000, resulting in a net income of \$55,000.

Under section 25, revenue act of 1928, certain credits are allowed against net income for normal tax purposes. Assuming that the taxpayer is a married man, living with his wife and assuming that he has one child, he would be entitled to personal exemption of \$3,500, plus \$400, or \$3,900. Furthermore, dividends from domestic corporations in the sum of \$20,000 are a credit against net income for normal tax purposes making a total credit of \$23,900.

The income subject to normal tax is therefore the sum of \$55,000 net income, minus \$23,900 credit, or \$31,100.

The aforesaid credits however are not allowed for surtax purposes. Surtaxes are not imposed on the first \$10,000 net income, so that the net income of \$55,000 is reduced by \$10,000 and the resulting \$45,000 is subject to surtax.



## Correspondence

### RESTRICTIVE LEGISLATION DEFENDED

*Editor, THE JOURNAL OF ACCOUNTANCY:*

SIR: In the January issue of *THE JOURNAL*, I read an editorial dealing with restrictive legislation and a decision thereon emanating from the supreme court of South Carolina.

As this is a matter in which all practising accountants are more or less interested, and one which, like the question of national prohibition, provokes heated discussion, I feel that I am somewhat justified in presenting some extended remarks on this controversial subject.

In the first place, let us ask the question "Why do qualified and reputable accountants favor restrictive legislation?" There must be some deep-seated motive, because discerning men do not long pursue a course of action without having a reason which, to their minds at least, seems fair and satisfactory. I have spoken about this subject to different accountants who reside in different sections of the country and they all give in effect the same answer, though phrased in different words. Some of them say that they need restrictive legislation to keep the large accounting firms out. Others say that they need it to hold their own business. Whether one accepts the negative or the positive view, the meaning is the same. These men feel that, after years of study and practice and the building up of a clientele from which they derive their livelihood in a community, it is not in consonance with the dictates of reason to permit, without an effort on their part, the large accounting organizations to come into their particular state and deprive them of the income from the life vocation which they have voluntarily chosen. One of these accountants further said that the Institute frowns upon a member who solicits the clients of another member, and properly so, but that the large organizations when expanding into other states do precisely the same thing but by a different method and on a far more colossal scale. He further stated that the local or individual accountant was perfectly justified in his opposition, for to him it meant livelihood and the protection of himself and family, while to the large aggressive firm it simply meant expansion and more business.

Now, when accountants are actuated by such deep-seated motives as these, they naturally enlist the aid of business men and appeal to their state legislatures for aid in the form of restrictive legislation. This in turn arouses the ire of the large firms and the profession is in a turmoil. And naturally so, because the large firms through the aid of their extensive investments, branch offices, large corps of trained assistants and all the attendant prestige, can command large corporate consolidations and audits and perform this work with a degree of despatch and precision quite beyond the range of the smaller practitioner. And this fact is openly admitted. Yet the small accounting proprietor is not ready to admit that these are good and sufficient reasons for his

elimination or absorption by the larger firms. He takes the phrase of the Declaration of Independence literally that he is entitled to "life, liberty and the pursuit of happiness" and that having chosen his life-work, the machinery of government in the state of his choice must give him reasonable protection in its enjoyment. In other words he thinks there should be room for both classes.

If the above seems to be the gist of the contention among the members of the profession, the next question is "How can the controversy be settled?" Here two avenues seem to be open. One avenue leads to the courts and a constitutional question.

The other leads to a still closer affiliation between the members of the profession, more regional meetings of the Institute, a frank spirit of compromise between both classes of accountants with the view of encouraging each class to do the work for which it has the best facilities, instead of adopting the ruthless attitude of the tiger that kills out of sheer sport, regardless of the fact whether its hunger is satiated or not.

Let us now look at the first method of settling this controversy, that of the courts. This is not so assuring against the restrictive policy.

(1) The restrictive legislation complained of has been passed by the state under its police power and is certainly valid if it can be shown to be reasonable and in the public welfare. And the reasonableness of the legislation is primarily the duty of the legislature to determine. It will only be declared invalid by the court when it plainly transcends the limits of the police power of the state. I note that the learned judge of South Carolina recognizes this doctrine, because at the foot of page 6 of THE JOURNAL he uses the following language "Of course this court will always seek to hold an act of the general assembly as coming within the provisions of the constitutions of this state and the United States and will read its language with that purpose in mind."

Moreover the police power of a state is an attribute of sovereignty. We need sometimes to be reminded that our form of government is a dual one and that the one person is a citizen of the United States subject to the behests of the federal laws and at the same moment of time he is also a citizen of the state in which he resides and subject to the observance of a still larger and more varied collection of laws to be found in the state code. It is easy enough to recite this statement of dual citizenship, but it is not so easy to realize it as an every-day matter of fact. Under our form of government we have forty-eight state sovereignties, and while the state laws might be said to regulate the same subject matter, viz., contracts, land, wills, domestic relations, etc., yet the laws on these subjects are by no means uniform. However, since a state is a sovereignty, its legislature has *ipso facto* the general power to pass any laws in the interest of its own internal affairs, subject of course to its constitution, which is a part of itself, and the only limitation on this general power is to be found in the specific matters voluntarily surrendered by the people of all the states to the federal government and recited in the constitution of the United States. Therefore before Congress can act it must point to the right conferred on it through the constitution, since it is a creature of limited and not general powers.

Further, the police power of the state antedates by far the constitution of the United States. It existed during the old confederation, and may properly be said to have been vested in the states after the revolutionary war of 1776,

when they became sovereignties. During colonial days the police power was of course vested in the parliament of Great Britain. Because of these fundamental truths contained in this historic background, the tendency of the federal courts appears to be not to declare this kind of legislation void even in borderline cases, but only in those where federal encroachment is clear and evident.

(2) The 14th amendment to the United States constitution declares that no state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States. But this was held by the United States supreme court to mean, as the language imports, the privileges and immunities of national citizenship, and not to include those belonging to the citizen of the state. The law of a state declared that only citizens of the United States be employed on public works and that citizens of the state be preferred. It was challenged as violating the above amendment, but in 1915 the United States supreme court upheld the state law.

A state statute restricting the grants of retail liquor licences to citizens of the state is not an unlawful discrimination against non-residents, but is a proper police regulation. (*Austin v. State*, 10 Mo. 591, *et al.*) Of course this is now obsolete under national prohibition, but it illustrates the principle.

This amendment is not as all inclusive as might at first sight appear. It confers no political rights on a citizen of another state such as voting, running for office, etc., and in *McCready v. Virginia* (94 U. S. 391), it was even decided that a state law could restrict such rights as hunting and fishing to citizens of its own. A non-resident physician was prohibited from practising in the state except when called in consultation (*France v. State*, 57 Ohio St. 1, 47 N. E. 1041).

(3) The 14th amendment further declares that no state shall deny to any person within its jurisdiction the equal protection of the laws. In truth this amendment was written primarily for the liberated negro who is not mentioned in the amendment, but, since the language is without limitation, extending to "any person," it has been applied to many forms of inequality alleged to arise out of state laws. In the case *re Flukes* (157 Mo. 125) it is said that the word "protection" means the right to call to one's aid the laws of the state, attended by all their machinery of justice for the averting or redress of injuries or oppressions. But if a California accountant, for example being also a citizen of the United States, were refused a certificate to practise accounting in Oregon, because he was a non-resident of this state, and such were the Oregon law, would such a refusal amount to a denial of the equal protection of the laws? It does not so appear. Story on the *Constitution* says that this clause, of its own force, neither confers rights nor gives privileges, and that its sole office is to ensure impartial legal protection to such as under the laws may exist. Surely the right to practise law or accountancy can not be the right of a citizen as such. It seems that instead of being rights these are privileges granted by the state to certain citizens because of special qualifications and in the public welfare. Therefore, how can this constitutional amendment be invoked to protect the Californian accountant in the enjoyment of a privilege sought by him in Oregon, but of which he is not yet possessed, and of which he can not be possessed until he complies with the Oregon law by becoming a resident?

The legal points heretofore discussed appear to be those most appropriate to our controversy, and in support of the exercise of the police power of the state,

## Correspondence

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but no one can be sure of the result of litigation and the most that can be done is to show tendencies through former adjudications. Even the learned justices disagree, as is well known from the majority and minority opinions rendered.

Regarding the case decided by the supreme court of South Carolina, the court simply followed the statute. The state board of accountancy made a ruling contrary to the provisions of the statute and in so doing tried to take the place of the legislature. This is a salutary lesson to state boards whose members seem to think that they are justified in making any rulings they deem necessary whether to carry out the purpose of the act or otherwise, and I can vouch for the fact that such practice is not by any means limited to South Carolina.

That portion of the court's decision which speculates upon the possibilities of "unconstitutionality," in case the accountant had been required to maintain an office in the state, is merely an off-hand opinion in passing, has no legal effect in the case, and is purely *obiter dicta*.

If such a state of facts were properly before the court and the authorities consulted, it is difficult to say just what the learned jurist's opinion would be. Until such a time arrives the conclusion arrived at can not be taken seriously and has no value as a precedent. The bad feature about it, however, is that it has such an appearance, and many persons will regard it as such.

There were also *obiter dicta* uttered by the celebrated Chief Justice Taney in the *Dred Scott* case. The effect was to encourage the southern states in their viewpoint of the slavery question, and this ended disastrously in the civil war. It is always best to arrive at decisions based on the facts of the instant case. Keep away from prophecy, and permit the future to take care of itself.

And now that the issues of this litigation have been settled by me in favor of the states (to which the opposite side will, of course, never agree) let me state frankly that I think this is a problem for the accountants themselves to work out through the American Institute. But it can only be done in a spirit of conciliation and compromise. Even that venerable document—the constitution of the United States—was born in the spirit of compromise. It was not possible otherwise. No accountant is as great as the profession to which he belongs. He has his status because of it and owes it loyalty. There are men of varied talents in it, the keen and the mediocre, the well to do and the fairly prosperous, the grave and the gay. We have striven since 1896 to give it proper recognition in the economic life of the state and nation. Today this is an accomplished fact. Let us keep the professional view-point and not quarrel about big business. There should be room for all. As a member of the American Bar Association I know that through a fine spirit of coöperation that organization is accomplishing uniformity in legislation that could not have been obtained otherwise. If argumentative persons can coöperate, certainly accountants can.

Yours truly,

ARTHUR BERRIDGE.

Portland, Oregon, January 14, 1931.

## Book Reviews

MUNICIPAL ACCOUNTS EXEMPLIFIED, by STANLEY WHITEHEAD.  
*Gee & Company, London. 99 pages.*

*Municipal Accounts Exemplified* is No. XI of "The accountant students' library" and an examination of it arouses an amount of interest entirely out of proportion to its modest size. The book deals solely with municipal accounts; it is written by a master of the subject, not so much for officers as for students of accountancy, and, evidently, is based on experience gained in the office, rather than on theories developed in the academy. The volume arouses further interest from the fact that it is written in, and applies to, the practices followed in Great Britain, where the procedure differs from that in the United States, as do many of the expressions in current use.

Notwithstanding this, the same basic theories prevail in both countries and both are suffering from the same affliction, for Mr. Whitehead says, "It is probably true that, speaking generally, the accounts of local authorities are no nearer standardization today than they were twenty years ago"—a statement which unfortunately is equally true in this country.

The book consists of twenty-two short chapters, nine of which are devoted to income from all sources and the manner of dealing with it; three chapters deal with "Rate estimates," which most officers here would call budgets. Then follow chapters on the allocation of wages, on stores accounts, impersonal ledgers, redemption-fund contributions, closing the accounts, superannuation funds and the "annual abstract of accounts and epitome of accounts." Each branch of the subject is fully illustrated by examples, forms and pro-forms journal entries.

The author emphasizes two of the most important matters in municipal accounting. First: of the standardization of accounts he writes: "Before we can begin to consider the standardization of accounts it is, of course, imperative that the closest consideration should be given to the question of standardization of analysis of income and expenditures; it is futile agreeing to the final accounts being prepared in accordance with a standard, unless the items going to make up the income and expenditures under each standardized heading have also been dealt with in a uniform manner."

The truth of this statement is obvious. Experience indicates that disregard of the principle is quite generally equally obvious.

Secondly—and this is of the greatest importance—he lays stress upon the form of the "epitome of accounts" by which he means the summary, or condensed statement, which is read by the man on the street, the taxpayers and the public.

For many years I have insisted that the usual reports of municipal accounts are unintelligible to the average taxpayer and that there should be substituted for them non-technical stories of the activities. Therefore, it is with joy that I read the following comment by the author: "No good purpose will be served by a reiteration of a mass of figures which may already be found in the abstract of accounts, but rather should the epitome contain statistical information conveyed in such a manner as will impress anyone reading it, even though he may have no knowledge whatever of accounts."

## Book Reviews

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If such words induce a single municipal auditor to follow the suggestion, the entire book is justified.

To the auditor or student who prepares reports mechanically, this book offers little of value, for owing to differences in procedure and nomenclature he will find no form he can casually copy, but to the student who studies, the book presents a picture of what others do in circumstances similar to his own, which is interesting, illuminating and perhaps suggestive.

WALTER MUCKLOW.

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CASUALTY INSURANCE ACCOUNTING, by ROBERT SEDGWICK HULL.  
*The Ronald Press Company*, New York. 325 pages.

The author of *Casualty Insurance Accounting* has made an exhaustive study of the subject, and has compiled a very complete compendium of information that should be in the possession of those whose duty requires a knowledge of accounting for casualty companies.

He begins with a review of the fundamentals underlying all accounting, and while this is not a complete treatise on bookkeeping by modern methods, it is as full as one could expect in a specialized work. Passing then to his special subject, he clarifies the somewhat confused concept of reserves, pointing out that to an insurance man a reserve is something very definite and specific, which is quite different from the commercial idea of a reserve.

Insurance accounting is influenced almost entirely by the necessity to furnish certain required information as of December 31st each year in a form prescribed by a committee of the insurance commissioners of the several states. This form requires statements to be rendered on a cash basis as regards income. The statement of "income," so called, is in fact a statement of receipts, and this together with the statement of disbursements shows the increase in so-called "ledger assets." This latter title implies the existence of "non-ledger assets," including all accruals, which must also be accounted for, and by further inference a statement of liabilities not appearing on the ledger, but nevertheless fully accounted for in subsidiary books.

While the foregoing applies to all insurance companies, there is a modification in the case of casualty (and also fire) in that premiums must be reported on an accrual basis, being taken up into the books as income as soon as written. "Not all companies," says the author, "agree as to the wisdom of this method, but the practice is virtually standardized by the requirements of the annual statements."

The important points of insurance accounting (presenting problems not met by those outside that field) are well brought out. For instance, there is the hardship imposed upon casualty and other companies by compelling them to set up in full as a reserve the unearned portion of premiums received, denying the right to take into account the relative expense in the acquisition of the business which has been paid in cash and must be taken up in full. Thus it might happen that a company making progress too rapidly would find its surplus, or even its capital, impaired according to the statement it must render. However, it is a protective measure for the security not only of the public but of the insurance companies themselves.

The problem of estimates is fully dealt with and it is made clear that although several important items are the result of estimates, experience has taught the officers to make these estimates a very close approximation to the existing facts, as is shown later when the facts are discovered.

A large part of the book deals with the inter-relation of statistics and accounts, and the handling of details which are so voluminous that the latest modern devices in bookkeeping, tabulating and calculating machinery must be used, and such use is very well described.

The organization of a casualty company is clearly outlined, especially the position of the company's auditor (other than public accountants) and the author makes it a strong point that the company's auditor should be an independent officer reporting direct to the president or general manager, since he is auditing the accounts of other officers, such as the comptroller and the treasurer. The comptroller, while technically the head of the accounting system, may frequently in practice discharge the function of auditor under another name, and only in this case should the auditor be under him. The value of an outside audit, however, is not overlooked by the author.

Enough has been said to show that the book will prove of great value to those dealing with casualty accounting problems whether from the viewpoint of an officer of a company or an independent auditor.

CHARLES E. MATHER.

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INTRODUCTION TO ACCOUNTING, by PRICKETT AND MIKESSELL. *The Macmillan Company*, New York. 374 pages.

The authors of *Introduction to Accounting* are professors of accounting in Indiana University. The volume "had its origin in the need for a text adapted to use in a one-year required course in accounting," presumably in that university.

The first chapter deals with the development of business analysis. It traces this development from Babylonian times to the present. While purely introductory this chapter is particularly interesting.

There are twenty-three other chapters, dealing with accounting principles and methods. These are arranged in the usual form for teaching purposes. They include the following: balance-sheet and the profit-and-loss statement, accounts, the ledger and the trial balance, journals, adjusting entries, the working sheet, closing entries, controlling accounts and subsidiary ledgers, business forms and vouchers, interest and discount, types of business organization, partnership accounting, the corporation and capital stock. Following each chapter are questions and problems.

With respect to subject matter this book does not differ from others of its kind. However, it does present accounting principles in a clear and understandable manner and, therefore, is well adapted for teaching purposes.

W. B. FRANKE.

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PROBLEMS IN INDUSTRIAL ACCOUNTING, by THOMAS H. SANDERS AND PAUL B. COFFMAN. *McGraw-Hill Book Company*, New York. 816 pages.

The joint authors of *Problems in Industrial Accounting* are a professor and an assistant professor of accounting at the graduate school of administration of

## *Book Reviews*

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Harvard University. The purposes of this work, as explained by the authors, are as follows:

"The traditional course in cost accounting, with its prescribed routines, is no longer sufficient; it is necessary to present concrete and representative examples of the varied situations in which cost analysis serves and of the adaptations of method which are made to fit the situations. Many of the admitted difficulties of teaching cost accounting probably arise from not distinguishing details of method from matters of principle, and from failure to show the precise circumstances which make a given procedure appropriate and successful."

Cost accounting, in theory, is treated exhaustively in the standard works of A. Hamilton Church, Amidon and Lang, T. H. Sanders, and others, but actual examples of current practice are not given in those books in such a form as to be immediately translated into use.

*Problems in Industrial Accounting* supplies the need of a student or a practitioner by giving analyses of facts. The book is, in fact, a series of case studies of cost accounting applied to a large number of industries. The case studies are explained on the principle that the best method of learning how to do work is by doing it. This book states each problem from different points of view, using arguments for and against various suggested methods.

It also shows in most cases the solutions of the problems, with the forms actually used. The result is that instead of burdening the student with a mass of dry theory, he is enabled to see the actual working out of cost accounts. This is like the difference between reading a play and seeing it acted on a stage by capable performers.

The chief divisions of the book are the scope and objectives of industrial accounting, production costs, advanced problems in manufacturing costs, various applications of costs, commercial and financial costs, cost accounting in banks, organization of cost and accounting departments, and cost control in typical industries.

This book is commended to both students of accounting and practitioners who wish to see how cost difficulties have been surmounted in a large variety of manufacturing and financial businesses.

WILLIAM J. GREENWOOD.



## Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

### *INSTALMENT PURCHASE OF REAL ESTATE*

*Question:* Will you send me some information with reference to the correct way to record on a balance-sheet real estate being purchased under an instalment contract. Which of the following three ways should it be reported:

- (a) The net amount paid as an equity;
- (b) The gross purchase price on the asset side of the balance-sheet, less the unpaid balance of the contract with the balance extended as equity owned;
- (c) The purchase price of the real estate shown on the asset side as real estate being purchased under contract, and on the liability side the balance of the contract shown as an instalment real estate contract payable?

*Answer:* Such transactions as are referred to fall into one of two classes:

- 1. Those in which the obligation is assumed by the purchaser.
- 2. Those in which the contract gives the purchaser merely the right to buy the property, but he does not enter into an obligation to complete the transaction.

In class 1 there is a definite liability and, in my opinion, the proper way to enter such transactions is to show the purchase price among the assets and to set up the unpaid portion as a liability which is reduced as each payment is made. It sometimes happens that this liability is in the form of periodic instalments. In that case a portion of it might fall under "current liabilities" and a portion under "deferred liabilities."

As to class 2, the purchaser has no liability and I think the best way to show the transaction is to place the amounts paid among the assets. This may be done in one of two ways, as indicated by your correspondent under (a) and (b). These two methods give the same result but 2 gives full information and I therefore think it is to be preferred to 1.

### *BEDAUX POINT SYSTEM*

*Question:* A client of ours has raised a question with regard to using the Bedaux wage-payment plan as a method of distributing manufacturing overhead.

## *Accounting Questions*

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A company manufacturing food products consisting of 1,200 standard items has been operating a standard cost system for a period of years. It is now installing the Bedaux wage-payment plan. This plan as a measurement of labor "is based on the principle that all human effort may be measured in terms of a common unit, that unit being made up of a combination of work and rest. The Bedaux unit, or B, is a fraction of a minute of work plus a fraction of a minute of rest, always aggregating unity, but varying in proportion according to the nature of the strain."

In the Bedaux plan the "B" is a basic element of control. All details of the system are computed, classified and spoken of in the terms of "B's".

To what extent can the Bedaux wage-payment plan be coordinated with the standard cost system?

Can the "B's produced" be used as a method of distributing departmental manufacturing overhead?

Would you recommend building up labor and overhead cost around "B's" and training your cost department to think in terms of "B's"?

*Answer:* The answer to the question as to what extent the Bedaux wage-payment plan can be coordinated with the standard cost system is materially affected by the definition given to a standard cost system. Some standard cost methods are based on the results of past experience for normal production activities; while in other instances standard costs are prepared to reflect the possible ideal rather than the actual past accomplishment. If experience standards are used, we believe the Bedaux wage-payment plan can be coordinated with the standard cost system. However, if expected or ideal accomplishment is the basis of the standards it seems impracticable to attempt to coordinate the Bedaux plan with such a standard cost system, because under the Bedaux plan the point value of each operation is usually based on past performance rather than on the theoretically possible production, and it would, therefore, be necessary to compile other standard costs on the latter basis.

Where standards are based on past experience, the operation of a standard cost system with respect to labor requires:

1. The establishment of unit standard labor costs for each of the standard items.
2. The accumulation of a standard value of production, by the application of the standard unit costs to the quantities produced.
3. The determination of actual cost of production from payroll distributions.
4. The computation of the labor variance or difference between the standard value of production and actual cost.

The expected production of "B's" seems a practical basis for establishing standard unit labor costs because the "B's" acquire monetary values. The second, third and fourth steps in standard cost procedure, stated above, present no special problem.

The effect of distributing overhead upon the basis of the "B's" produced is similar to the result obtained where a direct-labor-dollar method is used for straight piece-work wage payments. Most elements of overhead benefit direct manufacturing operations in direct proportion to the time the facilities are in use; hence overhead distributions based on units produced may not give proper weight to this time element. Production increases should ordina-

rily result in lower overhead charges per unit and conversely curtailed production tends to increase unit overhead costs.

It not infrequently happens that overhead distributions based on production ("B's" produced) are sufficiently accurate for practical purposes, due to the fact that the relative output of various production centers remains fairly constant. Distribution on such a basis would be very simple from a clerical standpoint. Determination as to whether it would be accurate enough must depend on a study of the facts in each case.

The Bedaux wage-payment plan is a useful and practical application of wage incentives, but it is not a substitute for sound factory accounting. The records of business are written in terms of dollars and cents. The true measure of performance of a workman or of the executive is the relation existing between a fairly established standard and actual results, both expressed in a language understood not only by cost clerks, but by department heads, company officers and the public.

We are of the opinion that while the "B" may be a useful symbol as an expression of the amount of work assigned to 1/60 of an hour, or one minute, and serves as an intermediate measure of performance for purposes of payroll computation and related production statistics, it has no place in the accounting records, which must be so kept as to be understandable by those not versed in the technicalities of the Bedaux plan.

To summarize briefly, we believe it is practicable to coördinate the Bedaux wage-payment plan with the standard cost system when standards reflect past experience, and that "B's" may be used as a method of overhead distribution if such a basis is suitable for the operations of the business under consideration. However, we would not recommend that labor and overhead costs be built up around the "B's" or that the cost department be trained to think in terms of "B's".

#### *DISCOUNT AND PREMIUM ON CORPORATION BONDS*

*Question:* In a recent audit, the enclosed problem presented itself. Having followed numerous opinions expressed by you through THE JOURNAL, we would be interested in knowing just how you would have handled the situations surrounding the purchase of the bonds.

Company A has outstanding bonds 5% of \$200,000. These are 30-year bonds maturing in 1937 and are not callable. Records unavailable and current balance-sheet shows no unamortized debt, discount and expense.

Company B 5% bonds outstanding of \$700,000. These are 40-year bonds maturing in 1950 and are not callable. Original discount and expense \$100,000.

A and B merge. Consolidated corporation is known as company B. Company B assumes all liabilities of company A.

Company B executes a first and refunding mortgage and issues 5½% bonds maturing in 1957 for the purpose of "(a) paying or refunding or to be exchanged for bonds heretofore issued by company A and by company B and/or for bonds of any other series that shall have been issued in pursuance of this indenture; (b) to provide capital for enlarging, etc.; (c) to pay obligations heretofore contracted, etc.; (d) to acquire and/or develop additional plant capacity."

At the time of the issuance of the first and refunding bonds, the unamortized balance of discount and expense on the old bonds was \$75,000.

### *Accounting Questions*

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Of the new bonds \$800,000 were sold for cash at 98, \$650,000 were exchanged for old bonds of company B and \$195,000 were exchanged for old bonds of company A, leaving \$50,000 of old company B bonds and \$5,000 of company A outstanding.

Provisions of the new mortgage are that all reacquired bonds of previous issues are to be held as collateral on the new mortgage.

In acquiring some of the old bonds a premium was paid, in no specific amount, but just the amount necessary to effect the acquisition. This premium amounted to \$12,000.

In setting up the modified balance-sheet what disposition should be made of:

- (a) The unamortized balance of discount and expense on bonds which have been reacquired.
- (b) The premium paid at acquisition of \$12,000.

The fourth paragraph of your letter states that:

"A and B merge. Consolidated corporation is known as company B. Company B assumes all liabilities of company A."

If A and B merged, there was no consolidation and no new company was formed. We assume, therefore, that instead of the word "consolidated" it was intended to use the word "merged" in the second sentence of the foregoing paragraph.

After all of the new  $5\frac{1}{2}\%$  bonds have been issued, company B will have on its books a balance of \$75,000 of unamortized discount and expenses applicable to the \$700,000 of old 5% bonds. Since only \$50,000, or  $1/14$  of the old bonds remain outstanding, only  $1/14$  of the foregoing sum, or approximately \$5,357, should be carried as an asset on the balance-sheet. The remainder should be charged off against surplus. The premium of \$12,000 paid on acquisition of the old bonds should likewise be charged to surplus. However, there is some justification for the view that the balance of the old discount-and-expense account—\$69,643—as well as the \$12,000 premium should be amortized over the life of the new bonds issued in exchange. The first treatment is more conservative and, on that account, preferable.

The problem does not state specifically whether the new bonds were exchanged for the old on a par-for-par basis but, since \$800,000 of the new bonds were sold for cash at 98, it has been assumed that the exchange was on a par basis, and that the difference between 98 and 100 represented financing expenses.

*Answer:* It is our opinion that the unamortized balance of discount and expense on bonds which have been reacquired should be deferred on the "modified" balance-sheet and written off over the remaining life of these bonds. We are also of the opinion that the premium paid in acquiring some of the old bonds should be deferred and written off over the life of the new issue, this premium representing a part of the cost of issuing the new bonds.

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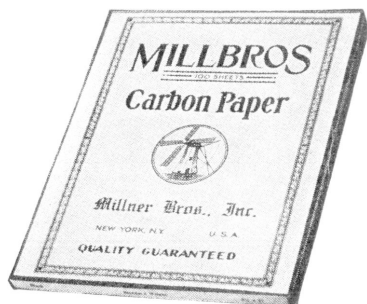
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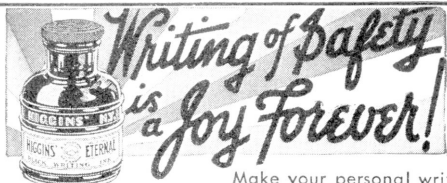
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